UNIVERSITY OF PENNSYLVANIA

BUSINESS INTERRUPTION INSURANCE

(A Survey of the Coverage of Business Interruption Losses Caused by Fire and Allied Hazards, Other than Marine)

CLYDE M. KAHLER

A THESIS

IN ECONOMICS

PRESENTED TO THE FACULTY OF THE GRADUATE SCHOOL IN
PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
THE DEGREE OF DOCTOR OF PHILOSOPHY

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PREFACE

The interruption of business which follows the destruction of property frequently results in a loss of significant proportions. The need for some form of insurance to indemnify for this loss has long been appreciated, but only in recent years has it been adequately fulfilled. The intangible nature of the risk to be assumed and the many problems to which it gave rise caused much opposition to be voiced against the assumption of business interruption risks by insurance companies. This, in part, accounts for its tardy development.

With the coming of the World War and the huge profits realized by many industries, there arose a considerable demand for the various types of business interruption insurance. The wide variety of forms which had been in use were assembled by the Uniform Rules and Clauses Committee of the Eastern Union, and uniform forms which incorporated the best features of the forms existing at that time were promulgated. This was the first unified attempt to solve the problems which this class of insurance involved. Since that time many changes have been made in the forms and rules of the different types of insurance of this class. Many other changes are still necessary.

It is the purpose of this thesis to explain the present system of insurance against business interruption losses and to analyze its development; to present the problems which still require solution and to attempt their solution whenever possible. No adequate analysis of the field has been made up to the present time, in spite of the fact that it is recognized as a most potential source of future growth. Literally hundreds of articles have been published but virtually all of them have had as their goal the education of agents and brokers in the elementary principles of the available contracts so that this growth might be realized.

In the first Chapter the types of insurance which qualify as business interruption forms of insurance are considered, the limits of the treatise set forth, and the history of insurance leading up to the origin of this class of protection is examined. The forms of insurance comprising the business interruption insurance group to which the treatise is limited are rent or

rental value insurance, leasehold interest insurance, use and occupancy insurance, and profits and commissions insurance. In Chapter II the insurable interests which are necessary, and the insurable values which may be supported for each of these types of insurance are considered in detail. Following this point the different types of insurance are considered separately since the variations in the underwriting practice of each type of insurance from any general principles which might be established would require many cumbersome qualifications. The analysis of each type of insurance proceeds along the same lines. The historical development of the contract up to the present time provides a background for an understanding of the present forms. These forms are then analyzed, their application under various circumstances explained, and their deficiencies pointed out. The system of rates for each type of insurance is then considered and criticized, and the more important conclusions and suggestions as to each type are summarized.

Unfortunately the development of an adequate system of business interruption insurance has been hampered by the fact that it has always been considered as a part of the direct damage insurance of the particular hazard. For a satisfactory analysis upon which a future program may be based, experience relating to business interruption insurance losses must be segregated, separately classified, and analyzed independently of the experience upon the direct damage insurance.

The author wishes to express his appreciation of the generosity with which many of the underwriters' associations or rating bureaus and numerous insurance company officials met his requests for information. Special acknowledgment is due also to Dr. S. S. Huebner, Dr. C. K. Knight, Dr. H. J. Loman and Dr. C. A. Kulp, Professors of Insurance at the University of Pennsylvania, to Mr. John Kremer, Vice-President of the Insurance Company of North America, and to Mr. W. S. Foster, Assistant Manager of the Western Department of the Insurance Company of North America, all of whom read the manuscript and offered valuable criticisms and suggestions.

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C. M. KAHLER.

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I

Introduction and Early History

Business interruption insurance may be defined as any form of insurance the purpose of which is to indemnify for losses resulting from an interruption of the regular course of a business. The various forms of insurance included within the scope of this definition are capable of a three-fold classification according to the cause of such an interruption:

1. Those forms insuring against interruption losses caused by the death or incapacity of one essential to the conduct of the business.
2. Those insuring against interruption losses directly resulting from the occurrence of an insurable hazard, without any damage to physical property.
3. Those protecting against interruption losses brought about by damage to or destruction of property by some casualty.

Interruption Insurance of the First Type.

Carrying the definition to its logical conclusion *life insurance* may be, and usually is, business interruption insurance. Insurance on the life of one whose services can be replaced only after considerable delay, or after considerable training, reimburses the business for its loss occasioned by the interruption consequent upon his death. The interruption may be evidenced by a temporary suspension of the business, a reduction in the volume of business done, or an increase in the cost of doing the same amount of business. Such a life insurance policy is a valued one, as are all life insurance policies, and, depending upon the amount of insurance carried, the business may be under- or over-indemnified. The amount of insurance carried in favor of the business should have been determined on the basis of the length of time necessary for the training of one to take the insured's place and

his value, per unit of time,[1] to the business. Since individuals are not replaced by purchase, as is property, the life insurance policy for business purposes cannot be considered as a policy to provide funds for replacement, but only as a form of business interruption insurance. On the other hand, policies insuring against damage to property are replacement policies. For indemnification of losses resulting from business interruption, additional specific insurance is required.

Obtaining a livelihood is the business of everyone,[2] and anything which prevents one from attaining that end may be considered as the cause of an interruption to his business. In this sense, then, *life insurance*, and *sickness and accident insurance* carried by the individual may be considered as business interruption insurance, for their purpose is to provide indemnity during the period his regular business of gaining a livelihood is interrupted by sickness, by accident, or by death. This, too, is the principle underlying *workmen's compensation insurance*, though this aspect has been dwarfed, or lost sight of, by the fact that the responsibility for providing such insurance[3] is imposed by law upon one other than the beneficiary. So, too, the social aspects of *unemployment insurance* have detracted from its consideration as a business interruption form of insurance.

Interruption Insurance of the Second Type.

Another class of insurance which clearly is intended to reimburse an insured for a business interruption loss is *rain insurance.* The abandonment or postponement of an outdoor event means

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[1] This value is difficult to estimate in many cases, as is the length of time required to train someone to take his place. In some cases the loss will be permanent in that the individual's special ability may be irreplaceable, or in that, when replaced, the one taking his place may be able to demand a higher return for his services. The value of the individual is usually estimated in a lump sum, considering the possibility of permanent loss of good will and, consequently, of income, and the temporary loss of income occasioned by his death.

[2] The logic of considering the family as a business is well presented in *The Economics of Life Insurance*, S. S. Huebner, Appleton, 1927, p. 14 et seq. Considering it in this fashion, the idea that life insurance is business interruption insurance is apparent.

[3] Or some acceptable substitute.

lost or reduced revenue, or additional expenses for its promoters. Rain may cause a deficiency in the anticipated sales of a merchant, resulting in a loss of profits. These are truly interruption losses. In the same way sales or production may be diminished by the cessation of one's electric current, without damage to the property of the insured, so *electric current interruption insurance* has been developed to cover the consequent losses.[4]

Included within this type of business interruption loss, where no damage to physical property is involved, should be considered the losses of income, and consequently of profit, resulting from certain at present uninsurable hazards. A business may be suspended in whole or in part, or its sales may be reduced[5] through changing price levels, business conditions, policies of the management or many similar hazards.[6] In the past these have been considered uninsurable,[7] though the practice of hedging has provided insurance to some extent against the risk of price fluctuations in speculative commodities or the materials of which such speculative commodities become a part.[8] In this respect *hedging* may be considered as providing a form of business interruption insurance.

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[4] *Strike insurance*, protecting against "damage or loss, directly or indirectly, resulting from interference with, or suspension or interruption of business or the use and operation, wholly or partly, of a manufacturing establishment by reason of employees' strike," was written in the United States. (See Buffalo Forge Co. v. Mutual Security Company (1910) 83 Conn. 393; 76 Atl. 995; 39 Ins. L. J. 1347.) Of its existence today no evidence can be found. It is, however, still written in Germany and other European countries. (See Alfred Manes, "Coverages Little Known in America," *Journal of American Insurance*, April, 1928, pp. 13–15. Also *Versicherungs-Lexikon*, 1924, E. S. Mittler & Sohn, Berlin, pp. 1204–8.)

[5] It is evident that to constitute an interruption to business there need be no actual shutting down of a plant.

[6] Certain economists have held that profits are the reward for the assumption of these risks. (See F. B. Hawley, "The Risk Theory of Profit," *Quarterly Journal of Economics*, 1893, Volume VII, pp. 459–479; "Enterprise and Profit" and "Reply to Final Objections to the Risk Theory of Profit", *Quarterly Journal of Economics*, 1901, Vol. XV, pp. 75–105; 603–620. A brief statement of the theory appears in this latter issue on p. 610.

[7] Recently, however, announcement was made of a policy issued in England by the Sun Insurance Company by which the insurer became liable up to £200,000 in any year in which the insured (Vickers-Armstrong, Ltd., steel combine) failed to earn £900,000, recouping its losses on an agreed upon basis when, in later years, the insured's profits should exceed £900,000. (See *Philadelphia Public Ledger*, November 20, 1927.)

[8] Hoffman, G. W.—*Hedging by Dealing in Grain Futures*, 1925 (Privately published, Philadelphia, Pa.), pp. 3–4.

Interruption Insurance of the Third Type.

Freight insurance, indemnifying one who has an insurable interest for the money paid or payable for the use of a vessel or for the transportation of cargo,[9] is readily seen to be insurance against loss resulting from an interruption of the business of cargo transportation. The insurance may be payable to the shipper or to the carrier, but in either case the carrier is the one who is benefited.[10]

The owner of a building has as his business the renting or occupying of the building.[11] Upon its destruction or damage so

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[9] While freight insurance is a form of interruption insurance, it does not cover, except indirectly, losses resulting from delay, such as additional expenses for wages and provisions, nor does it cover loss of profits from the use of a ship when, as yet, no freight contract exists. To exclude specifically loss by delay, policies frequently contain the provision, "warranted free from any claim consequent on loss of time whether arising from a peril of the sea or otherwise." (See *Arnould on Marine Insurance and Average*, 10th Ed., 1921, Vol. 2, pp. 1005–6, Sec. 787,) though the English Marine Ins. Act of 1906 provides specifically to the same effect. (*Ibid*, Vol. 2, p. 990, Sec. 778). Mutual insurance associations (or Protection and Indemnity Associations) may cover, inter alia,

(1) "cost of the wages and provisions of the crew while the ship is ashore or disabled or under average repairs." (*Ibid*, Vol. 1, p. 115, Sec. 81), and

(2) "quarantine expenses and the expenses of disinfection in consequence of outbreaks of disease on the ship " (*Ibid*, Vol. 1, p. 116, Sec. 81.)

"Whether a ship owner can insure the profit which he expects to make by the use of his ship is a question which has not been determined." (*Ibid*, Vol. 1, p. 318, Sec. 238.)

Passage money is not included under a contract insuring against loss of freight (*Ibid*, Vol. 1, p. 314, Sec. 235), but may be insured by the passenger since it is paid in advance by him. (*Ibid*, Vol. 1, p. 313, Sec. 234.)

[10] Ordinarily the carrier has the insurable interest in freight which is necessary to support the contract. This is true, in the absence of any agreement to the contrary, in the United States and Great Britain, where the payment of freight is necessary only if the voyage is safely completed. It is also true under the principle of distance freight (freight which is payable in the proportion which the mileage completed bears to the total mileage involved in the voyage), but in such a case the shipper may also have an insurable interest. For the shipper to have an insurable interest in freight it is necessary that all, or part, of the freight be actually prepaid or payable to the carrier regardless of whether the cargo is delivered safely or not. Frequently, under such circumstances, freight is insured as cargo by adding it to the cost of the goods. In this case the carrier has been or will be indemnified by the shipper, wholly or in part, for the interruption loss occasioned by his inability to fully complete his contract of carriage, and the shipper will be reimbursed by his insurance.

[11] While this may be only incidental to the usual business of the insured it may be considered as in itself constituting a separate business.

that it is rendered unfit for occupancy he is deprived of his income, the rent from the property, upon which he may have depended to meet the interest and principal of a mortgage on the property, or he is under the obligation of paying rent to another for the use of a similar building until it can be replaced or repaired. Such a loss is a business interruption loss and can be insured against by a *rent or rental value insurance* policy if the hazards which may cause the damage are considered insurable. Where a building is leased and the lease requires the continued payment of the rent even though the property be destroyed, the lessee is in a position to suffer a loss of the rental value of the building. In this case the landlord's business (income) will not be interrupted. The lessee will suffer a loss through the continued payment of rent during his interrupted occupancy without receiving in return the benefits attaching to the use of the property. Protection against this sort of loss can also be procured under rent or rental value insurance forms.

A lease may provide that it may be terminated by either party in the event of a fire[12] damaging the property to a certain extent. The lessee then is relieved of the payment of rent for the property and has no need for rent insurance. He still may suffer a business interruption loss, however, through his inability to sub-let or occupy the building. Such a situation arises when conditions have brought about an increase in the value of the lease. Because of the termination of the lease the lessee is deprived of the additional rent which he could have obtained by sub-letting the property for the remaining term of the lease, or he is forced to pay a higher rent for the use of similar quarters for the same period of time. Such an interruption loss can be covered specifically by a form of insurance known as *leasehold interest or leasehold value insurance.*

When a property is used in the production or merchandising of goods or services, it is evident that but partial indemnification for the business interruption loss of the owner or lessee occupant is provided by rent or leasehold value insurance. These forms are intended to indemnify only for the loss of income directly

[12] The peril, fire, is referred to merely for illustrative purposes. Any other insurable peril would serve equally as well.

attributable to the building, *i.e.* the income-producing ability of the building alone. But to obtain an income from it the owner or lessee occupant has found it necessary to combine with it other capital and labor. He has installed machinery and other equipment. He has contracted for supplies, for labor, for advertising, for salesmen and officials and for numerous services. Upon the destruction of the building, he finds himself unable to use not only the building, but also the other materials and services for which he has contracted. His income has ceased in whole or in part. In the meantime his expenses under many of his contracts continue. Other costs cannot be avoided, and they produce little or no return. The profit from his business has disappeared. All of these are business interruption losses in addition to the loss of rent or leasehold value. Under such circumstances a more comprehensive form of insurance is necessary. This form is called *use and occupancy insurance.* It is designed to cover the loss of net profits on the business which is prevented, the fixed charges and expenses which necessarily must continue during a total or partial suspension of business but which otherwise would have been earned, and additional expenses incurred for the purpose of reducing the interruption loss.[13]

When finished goods, ready for sale, are destroyed the amount which can be recovered for their loss is limited, under other than a valued policy, to the actual cash value of the goods at the time of the loss, not exceeding the amount which it would cost to repair or replace such goods. This does not include the profit which would have been realized on the goods had they finally been sold. By their destruction their sale is prevented and the profit is lost. This may have been in the form of a difference between the cost and selling price of the goods, or, had they been in the hands of one who was to sell them on a commission

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[13] The constituent parts of such an interruption loss will be considered in detail in the next chapter, pp. 53–61. When the loss is one which may result from the inability to fulfill a favorable contract because of the destruction of the insured's own plant or the plant of another upon which he depends for his raw materials or power, the insurance may be written under a special form known as *contract insurance.*

basis, in the form of a commission. The loss is a business interruption loss and may be insured against under a *profits and commissions insurance policy.*[14]

The Limit of the Field to be Covered.

All of the foregoing forms of insurance policies are similar in that they are intended to cover losses consequent upon the interruption of business; losses of income which would have been obtained had the peril insured against not occurred. They are dissimilar as to the nature of the business income interrupted and, consequently, as to the measure of the loss occasioned by the interruption. They are also dissimilar as to the nature of the hazard covered, *i.e.*, as to the cause of the interruption, which gives rise to differences in the underwriting of the various risks.

It is not the intention of this thesis to embody a complete discussion of all of the different forms of insurance which may be considered as protecting against business interruption losses. To do so would be not only impractical but also unnecessary. The forms of insurance covering interruptions caused by the death or incapacity of individuals are already well-covered in existing treatises.[15] The field of insurance against business interruption losses resulting directly from the occurrence of the hazard insured against provides sufficient material for separate consideration. Rain insurance has been neglected both from a

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[14] Policies sometimes are issued providing for the adjustment of direct damage losses on finished goods on the basis of selling price rather than upon the cost to replace. Such is the case with the policies issued by many of the New England factory mutual fire insurance companies, and stock fire companies are allowed to attach a market value clause to their policies covering certain specific articles. (See Rule 69, Eastern Underwriters Association.) Under such circumstances the supplemental coverage offered by profits and commissions insurance is unnecessary.

In the insurance of grain or seeds located in, or consigned to, an elevator it is possible to obtain a form of insurance known as "*Charges Insurance*" which covers losses of storage charges and other items not recoverable under the policy insuring the grain itself.

[15] *Life Insurance*—Huebner, S. S., *Life Insurance*, Appleton (1923); Maclean, J. B., *Life Insurance*, McGraw Hill (1924); Various authors (S. S. Huebner, Editor) *Life Insurance Series—Its Economic and Social Relations* (7 volumes), Appleton (1928); Numerous treatises on Actuarial Science.

Accident and Health Insurance—Knight, C. K., *Advanced Life Insurance*, Wiley (1926) Chap. 24; Kulp, C. A., *Casualty Insurance*, Ronald (1928) Chap.

research and an underwriting standpoint. This form of protection is capable of considerable development, but this development must be preceded by specific research, especially in the application of meteorological knowledge to the determination of the rates to be charged. Separate attention should also be devoted to the important subject of freight insurance. Up to the present time the only portion of this field to receive the consideration which it deserves has been the law relating thereto.[16] It also presents many problems which find no parallel in the other forms of insurance with which it has been classified. This study, therefore, shall be limited to the forms of insurance provided against loss resulting from the interruption of business caused by the destruction of, or damage to, property by fire and allied hazards other than marine. Whether the hazard which may cause the property damage is fire, windstorm, explosion, or any other insurable hazard makes no difference, the underlying principles of these forms of insurance are the same; consequently the major portion of the treatise may be confined to a consideration of their underwriting when the hazard involved is fire. It has been in connection with the fire hazard that business interruption forms of insurance have found their greatest development, the insurance of business interruption risks against hazards other than fire having followed closely the experience of the fire underwriters.

The Origin of Business Interruption Insurance as Such.

The idea of specifically insuring against interruption losses resulting from the destruction of physical property is of com-

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25, and Bibliography cited, p. 597; see also various treatises in Proceedings of the Casualty Actuarial Society and Transactions of the Actuarial Society of America.

Workmen's Compensation Insurance—Michelbacher and Nial, *Workmen's Compensation Insurance*, McGraw-Hill (1925), and references cited therein, pp. 484–489; Kulp, C. A., *Casualty Insurance*, Ronald (1928), Chaps. 3–14, and references cited, pp. 591–595; Numerous publications of U. S. Bureau of Labor Statistics; Proceedings of the Casualty Actuarial Society.

Unemployment Insurance—Cohen, J. L., *Insurance Against Unemployment*, (1921).

The above lists are nowise complete. They are intended only to illustrate the fact that these fields have already received consideration.

[16] Lazarus, G. M., *The Law Relating to the Insurance of Freight*, Butterworth & Company, London, 1915.

paratively recent origin. Freight insurance antedates any of the other forms, a policy covering an interest in freight having reached the courts as early as 1746.[17] That this should be the case is easily explained. Prior to the industrial revolution the only ventures involving any great possibility of loss were maritime ventures. Voyages being long and perilous, the interest in freight was relatively high in comparison with the value of the vessel. Before the advent of the factory system production was carried on in the homes of the workers. One place served as well as any other for the production of goods. Simple tools were used and were easily replaced. The risk of an interruption of production was distributed over dozens of homes and consequently was a matter of little concern to the entrepreneur. With the advent of the industrial revolution, bringing specialized machinery and the concentration of production in specialized buildings, the replacement of equipment and the obtaining of new places in which to carry on production no longer could be accomplished in a minimum of time. The risk of an interruption of business assumed significant proportions.

The earliest reference to insurance for the purpose of indemnifying for the loss of use of property destroyed or damaged by fire is found in a prospectus issued by the Beacon Fire Insurance Company which was organized in London in 1821. In its original prospectus it stated that the company offered, in addition to the usual forms offered by other companies, "The insurance of rent during the rebuilding of the premises" and "The insurance of a weekly allowance to tradesmen and others during the period they are deprived by fire of the means of pursuing their usual vocations."[18] In 1827 the company failed.

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[17] Tonge vs. Watts, 2 Strange, 1251—See Lazarus, *Opus cit.*, Table of Cases pp. XI–XXIV.

[18] Walford, *Insurance Cyclopedia*, 1871, C. and E. Layton, London, Vol. I, p. 260. While insurance against the loss of rent did not originate before this time, it is interesting to note that in the earliest days of fire insurance (beginning just after the London conflagration of 1666) the rental value of a property was used as the basis for fire insurance rates. See E. R. Hardy, *The Making of the Fire Insurance Rate*, Spectator Company, N. Y., 1926, pp. 7 and 8. Also reproduction of Table of Rates in F. H. Haines, *Chapters of Insurance History*, Posts, 1926, opposite p. 61.

Early Attempts to Recover for Interruption Losses.[19]

In 1834 one of the first attempts was made to recover for an interruption loss under an ordinary fire insurance policy.[20] Charles Wright, proprietor of the "Ship Inn" at Dover, England, effected insurance with the Sun Fire Office in November 1832. The policy covered, "on their interest only in the said Ship Inn and offices £1000." Wright claimed "also such damages as he can satisfy the arbitrator he has sustained under the claim delivered to the Sun Fire Office for his loss in his interest in the said Ship Inn and offices; such damages consisting in rent paid by him to his landlord, the hire of other houses or apartments whilst the apartments damaged in such inn by the fire were undergoing the necessary repairs, and the loss or damage sustained by him by reason of various persons refusing or declining to go to the said Ship Inn whilst the apartments so damaged were undergoing such repairs." The arbitrator had granted an award of £450 to cover the loss sustained by Wright in not having been able to occupy the premises during the time that elapsed between the fire and the rebuilding of the inn. It was decided that the "profits of the business were clearly insurable, but are they covered by the insurance actually effected? . . . If a party would recover such profits as these, he must insure them as profits."[21]

In 1842 an attempt was made in the United States to recover, under an ordinary fire insurance policy, for loss of rent during the time used by the insurance company in rebuilding the destroyed properties. Here again it was held that, "The general principle that the insurers are bound to adjust a loss upon the principle of replacing the insured, as near as may be, in the

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[19] Present-day direct damage insurance policies specifically exclude "compensation for loss resulting from interruption of business, or manufacture."

[20] In the Matter of Arbitration between Charles Wright and Charles Pole. Cases in Trinity Term 1834. 1 Adolphus & Ellis 621; 3 Nev. & Man. 819. See also the note following the decision in this case.

[21] It had been decided in 1781 that a policy insuring on goods did not cover the profit on the goods. It must be covered, in name, as profit. Grant v. Parkinson (1781) 3 Douglas 16. While the loss of profits on goods may represent a business interruption loss this case was not brought with the idea of procuring indemnity for an interruption loss, but, rather, with the idea of setting the sales price of goods as a measure of indemnity.

situation they were in before the fire, has never been understood to extend to the profits or fruits which the latter was drawing, or might have drawn, from the thing insured." The court further said that rent forms a distinct insurable interest and that separate insurance should be made upon it.[22]

In 1847 a case arose in which it was sought to recover not only the loss of profits and rent from the damaged premises, but also "£191, of wages which he (the insured) was obliged to pay the servants, and for which he could receive from them no recompense, as he had no building for them to work in." It again was held that specific insurance was necessary in order to recover the type of loss claimed.[23]

The cases which have been reviewed give support to the conclusion that, though it was possible to insure against interruption losses, the practice had not been adopted to any extent, otherwise recovery for such losses under ordinary fire insurance policies would not have been attempted. In further support of this view there appears an editorial in 1856[24] at which time an American official of an English insurance company claims to have originated the idea of insuring against loss of rents. His claim was disputed and evidence was offered that such policies had been written for twenty years preceding.

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[22] Michaela Leonarda, Baroness of Pontalba v. Phoenix Assurance Co. of London (Supreme Ct., La., April Term 1842)—2 Rob. (La.) 131; 38 Am. Dec. 205.—"There is much analogy between the rent of a house and the freight of a ship; both are the civil fruit of the thing from which they are derived. It is believed that the attempt has never been made to recover freight under a policy of insurance on a vessel, and yet the loss of the freight, like that of the rent, is a direct consequence of the destruction of the vessel. In both cases the loss falls on a thing which is no part of the object insured, and which is not, therefore, covered by the policy." The court here refers to *Phillips on Insurance*, Vol. 1, p. 190 and *Marshall on Insurance*, Vol. 2, p. 722.

[23] R. D. Menzies v. North British & Mercantile Insurance Co. (1847) 9 Session Cases (2nd Series) 694. (Scotch)

Other cases to the same effect rapidly followed. See Ellmaker's Executors v. Franklin Fire Insurance Co. (1847) 5 Pa. 183; Niblo v. North American Fire Ins. Co. (1848), 1 Sandford 551, 3 N. Y. Super. Ct. 551; Farmers Mutual Ins. Co. v. New Holland Turnpike Co. 122 Pa. St. 37, 15 Atl. 563.

[24] Alfred Pell, Esq., and His Scheme for the Insurance of Rents. In the *United States Insurance Gazette*, Vol. II, No. 12, April 1856, pp. 380–382.

"Chômage" Insurance.

The next development appears about 1860 in France where "chômage" insurance was introduced. This insurance was first applied to provide protection for workmen's wages in the event of the cessation of work in consequence of a fire,[25] the term "chômage" meaning "cessation of work" or "enforced idleness." It was then extended to cover any interruption loss by fire without regard to the specific items comprising the loss. Two types of policies were issued.[26] One provided that in the event of a loss a stipulated per cent per annum of the fire loss paid by the fire insurance company should be paid during the time necessary for the replacement of the damaged or destroyed property. For example, if the chômage policy called for 10 per cent chômage indemnity per annum, and, if a property insured for 500,000 fr. were damaged to the extent of 200,000 fr., the chômage policy would be liable for 20,000 fr. if it would take one year to repair the property, but would be liable for only 5,000 fr. if the damage could be repaired in three months. The other policy merely provided that in the event of a loss the same proportionate part of the policy should be paid as was paid under the ordinary fire insurance policy, without regard to the time necessary to repair or replace the property. In this case if the chômage policy amounted to 10 per cent of the amount of the ordinary fire insurance, and a 25 per cent loss were paid by the fire insurance company, then 10 per cent of the amount paid by the fire insurance company would be paid under the chômage policy, viz. 25 per cent of its face value.

While chômage insurance is based upon the admittedly erroneous assumption that an interruption loss is directly proportionate to the amount of the direct damage done by a fire, its adoption in the United States was urged.[27] That the fire insurance policy did not fully indemnify; that specific insurance against interruption losses was necessary, was now recognized.

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[25] *Insurance Times*, N. Y., August, 1878, p. 552; Joseph Hemard, *Theorie et Pratique des Assurances Terrestres*, Paris, 1925, p. 168. See also Macken, A. G., *Insurance of Profits*, Pitman, London, 1927, p. 3.

[26] *Insurance Times*, N. Y., August, 1878, p. 553; also *Posts Magazine* (July 7, 1900) Vol. LXI, No. 27, pp. 482–483.

[27] *Insurance Times*, N. Y., August, 1878, p. 553.

Origin of Use and Occupancy Insurance.

Instead of adopting the principle of chômage insurance in the United States an entirely new form of policy made its appearance about 1879. This form[28] was intended to cover losses of New England textile mills resulting from the prevention of the manufacture of goods upon the destruction of the factory buildings or machinery by fire. The amount of the policy was to be reduced by a specified amount each day throughout its term. In the event of a fire damaging the buildings or machinery it was the intention to pay the loss on a daily basis but the form was ambiguous in this respect. If a fire occurred on the last day of the policy term the amount of the policy would have been reduced to the daily amount specified and recovery could be had for only one day's interruption. No provision was made for cases where the fire caused only a partial interruption. In 1880 there appeared a greatly improved form,[29] then called "Profits Insurance," which form may be said to be the forerunner of our present "Use and Occupancy Insurance" system. Credit for the origin of this form is sometimes attributed to Mr. Edward

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[28] The earliest recorded form appears in C. C. Hine's *Book of Forms*, 2nd Edition, 1879. Form No. 74, p. 39.

"$15,000—On all their factory buildings, known as the Newton Mills, in Newton, Mass., from damage or destruction of their buildings, of machinery by fire, either or both, which damage or destruction may prevent the manufacture of goods. And the amount insured is to be $36,000 to be reduced $400 each day. This policy being reduced its pro rata amount.

"In the event of any loss or damage to the building or machinery by fire, by which the daily delivery is prevented by such loss or damage by fire, the assured warrant on their part that any damage to the building and machinery, or either of them, shall be repaired and machinery started as soon as possible; and that no claim shall be made for any less time than a full day.

"And it is further agreed that if in consequence of fire the non-delivery of the goods, or a portion of them shall cause the purchaser of them to void the contract, the insurers are to pay the difference between the contract price and the price they actually sell for, to the amount of $400 per day. Time, 3 months, at 90 cents, premium $135."

The Insurance Times, April, 1880, Vol. 13, No. 4, p. 232, records a form almost identical in wording, stating that it had been used in New England many years before but that it had been dropped because the insurance companies were afraid of it. Careful investigation has failed to reveal its use prior to 1879.

[29] A copy of the form appears in the *Insurance Times*, April, 1880, p. 232, in *The Index*, Boston and New York, April, 1880, Vol. 9, p. 121, and also in C. C. Hine's *Book of Forms*, 3d Edition, 1882, Form 146, p. 63. Mr. Hine refers to it as a Product Policy.

Atkinson, then President of the Boston Manufacturers' Mutual Insurance Company. In other cases it is given to the cooperative efforts of Mr. Henry R. Dalton, then a Boston insurance broker, and Mr. A. W. Damon, then chief clerk and secretary of the Washington Insurance Company and later President of the Springfield Fire and Marine Insurance Company. The only contemporary reference to the subject in which any statement as to the authorship of the form appears[30] gives credit to Mr. Atkinson. Support is given to his claim by a statement to the effect that the use of the form was "mostly confined to the mutuals,"[31] though the stock companies quickly adopted it. His claim apparently went unchallenged for a considerable time. The best statement of the claim of Messrs. Dalton and Damon appears in a letter to the *Insurance and Commercial Magazine* over the signature of Mr. Damon.[32] While they have in their favor the fact that this line of insurance was promoted more actively by the stock insurance companies than by the mutuals it would seem that the burden of the evidence lies in favor of Mr. Atkinson.

The improved form provided for the payment of an agreed upon amount per day for each working day during which the

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[30] *The Spectator*, New York (1880), Volume 24, p. 187.

[31] *Insurance Times*, New York, 1880, p. 232. But in *The Spectator* (1880) Vol. 24, p. 187, the statement appears that the mutuals could not take up this line at that time and that Mr. Atkinson suggested the idea to some of the stock companies.

[32] *Insurance and Commercial Magazine*, May, 1917, Vol. 82, No. 5, pp. 117–118. Other statements appear in the *Standard*, Vol. 100, No. 14, April 2, 1927, p. 621 and in *Eastern Underwriter*, April 8, 1927. There is no contemporary reference.

The claim of Messrs. Dalton and Damon has been given much credence in later years. The story presented is interesting to note. About the time of the origin of this form of insurance the protection of New England mills by means of automatic sprinkler systems had been introduced. The stock fire insurance companies apparently did not meet the situation by substantially reducing rates. The mutuals, on the other hand, were accepting these special risks and giving the insured the benefit of the saving by returning a large portion of his premium deposit. This was resulting in the loss of business for the stock companies, and in loss of commissions to the brokers and agents. Mr. Dalton, a broker, suggested to Mr. Damon that some of this loss might be recovered by providing protection to mill owners against loss resulting from the prevention of production occasioned by fire destroying or damaging their buildings or machinery. The idea appealed to Mr. Damon and a form was prepared.

business was entirely prevented from producing, the "loss to be computed from the day of the occurrence of any fire to the time when the mill could, with ordinary diligence and dispatch, be repaired or rebuilt and the machinery replaced therein, and not to be limited by the day of expiration named in the policy." In the event of a fire causing only a partial suspension of production the company was to be liable for that proportion of the agreed upon amount per day "which the product thereby prevented from being made bears to the average daily yield previous to the fire, which, for the purpose of this insurance, is agreed to be $.. . . . goods per day." The policy was to be written on the basis of 300 working days per year and the amount of the policy was to represent three hundred times the amount promised for each day of a total suspension. This policy does not assume any relationship between the amount of an interruption loss and the amount of direct damage done by the fire. It proceeds on the basis that the loss depends upon the length of time the business is interrupted and that the amount of loss per day does not vary. Though this latter assumption is usually in error it must be conceded that the development of this form of insurance represented a step toward the correct underwriting of interruption insurance.[33]

Origin of English Profits Insurance.

While the insurance of interruption losses was being developed on the above basis in the United States a new idea originated in England in 1899.[34] A policy was devised[35] in which the measure of an interruption loss was taken to be the depletion in the

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[33] A discussion of the defects of this form and the development from it to the present "Use and Occupancy" insurance policies is reserved for a later chapter. See pp. 138, et seq.

[34] In *Post Magazine* (Oct. 23, 1897) Vol. LVIII, No. 43, p. 739, the Machinery Insurance Company, Ltd. announces a new departure, *i.e.* the issuance of a so-called "Profits Policy." There is no evidence, however, that this was anything but an extension of "chômage insurance" under a new name.

[35] A. G. Macken, *Insurance of Profits*, Pitman, London, 1926, pp. 8, 116–117. Mr. Macken gives credit for this new form to Mr. Ludovig Mann, but in *Posts Magazine*, April 1, 1905, Vol. LXVI, No. 13, p. 245, Mr. Gautier de Ste. Croix, Manager of the Consequential Loss Department of the Profits and Income Insurance Company, is referred to as the author of the system.

"turnover" of a business. The turnover after a fire was to be compared with the average turnover for a definite period preceding the fire. In this way the amount by which the turnover was reduced as the result of a fire was determined. The loss was then paid as a certain agreed upon percentage of this reduction. Under this system it was assumed that the sum of the profits lost and of the charges which continued bore a fixed relationship to the turnover of the business. The length and degree of an interruption were automatically taken into consideration when the reduction in turnover was ascertained.[36]

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[36] A more complete discussion of this system and its development is reserved for a later chapter. See pp. 182–184.

II

Insurable Interest and Insurable Value

Insurable Interest and the Moral Hazard—Interruption Insurance Generally.

An insurable interest may be described as "Every interest in property, or any relation thereto, or liability in respect thereof, of such a nature that a contemplated peril might directly damnify the insured."[1] The necessity for an insurable interest in the subject matter of the insurance is obvious. Insurance contracts issued to one lacking such insurable interest would be purely wagering contracts condemned by law.[2] It is equally obvious that the contract must be a contract of indemnity or it would be akin to a wager. The idea that one should not profit as a result of the occurrence of a peril insured against is virtually as old as insurance itself.[3] But the idea that one should not lose under the same circumstances is of more recent origin. It was not until early in the nineteenth century that insurance to indemnify for the interruption losses caused by a fire was proposed.[4] While the fire insurance policy did not fully indemnify the insured for his loss, and while the fact that an insurable interest extended to cover more than the value of the property damaged or destroyed was recognized,[5] provision for the coverage of the additional losses not embraced within the fire insurance policy

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[1] California Civil Code Section 2536. It is not necessary to consider the nature of an insurable interest necessary to support an insurance contract involving life hazards.

[2] Vance, W. R., *Handbook of the Law of Insurance*, 1904, West Pub. Co., St. Paul. Minn., p. 98. Such contracts were permitted at common law but are now universally prohibited. See Sunderlin, C. A., *Fire Insurance*, Spectator Company, New York, 1928, Section 2, p. 11.

[3] Even under valued policies there was present the idea that a policy should not be issued for more than the value of the interest insured.

[4] See Chapter 1, p. 17.

[5] Reference to the cases already cited in Chapter 1, pp. 18, et seq. will establish this point. Other cases will be cited later.

was bitterly opposed.[6] This opposition may be attributed to the fact that the additional losses frequently were, and are, difficult to measure. There was a possibility that the insured could profit as the result of a fire and, consequently, the danger of the so-called moral hazard.[7] It was contended that indifference as to whether a fire should occur, accompanied by less care on the part of the insured to prevent its occurrence and, perhaps, by actual carelessness or by arson, would result from this more comprehensive coverage. This naturally would increase the hazard of fire which would prejudice not only the additional insurance but also the direct damage fire insurance. That this was a real danger in the earlier days in which such risks were underwritten is unquestioned. As a result, these supplementary forms of insurance were written for only the very highest types of risks of unquestionable integrity. With improvements in the policies so that the real loss may be more accurately determined the possibility of profit from one's insurance has been diminished. The addition of insurance which will not allow the insured a profit from the insurance itself increases the hazard of fire no more than does the placing of additional direct damage fire insurance. So long as the policies restrict their indemnity to the actual loss sustained the moral hazard will be present to no greater extent than it is under the direct damage fire insurance. If the risk is undesirable as a fire risk it is also undesirable as an interruption risk. If it is undesirable as an interruption risk it is equally undesirable as a fire risk and insurance of either sort should not be written upon it. The most comprehensive of insurance coverage still leaves

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[6] See *The Spectator*, Vol. 24, No. 5, May, 1880, p. 187; Vol. 25, No. 5, November, 1880, p. 417; *The Weekly Underwriter*, Vol. 23, No. 14, October 23, 1880, pp. 241–242. Here is reported a meeting of the representatives of stock fire insurance companies at which, after many extreme expressions of disapproval of the supplemental coverages, resolutions were passed condemning the practice of "profits" insurance. See page 21, Chap. 1 (Use and Occupancy insurance originally referred to as "profits" insurance).

[7] Even direct damage fire insurance was questioned on the grounds of the moral hazard, "by holding out to a losing merchant or speculator the fearful temptation of a ready market for his property when that skillful salesman, fire, may dispose of it without loss, and perhaps without detection."—Griswold, *Fire Underwriters' Textbook*, 1872, p. 463, Para. 1486.

the merchant or manufacturer whose property has been destroyed faced with the risk of loss. He may lose many of his customers to a competitor because of his inability to carry on his business for the period of its interruption. It is probable that the major portion of his employees will be laid off and will find other employment, making necessary a reorganization of his force and the training of the new employees, with the consequent loss of efficiency when the business is again resumed. Even the most conservative now agree that there is little likelihood of these supplementary forms of insurance, properly underwritten, bringing to the surface any otherwise dormant moral hazard.

In view of the court decisions already cited,[8] and because of the fact that the fire insurance policies now in use specifically exclude the coverage of losses "resulting from interruption of business or manufacture"[9] and limit the recovery to the "actual cash value of the property at the time of loss or damage,"[10] it is necessary to insure the existing interest, in addition to the value of the property, specifically. While it generally is not necessary that the interest be specially described in the policy, in some cases the nature of the specific interest may be such that a special description is required.[11] The interest or interests which arise out of the possibility of an interruption loss following the damage to or destruction of the property are such interests as to require specific description.[12] For the reason that the party

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[8] See Chapter 1, pp. 18–19.

[9] New York Standard Fire Policy—Insuring Clause.—Where, under an ordinary fire insurance policy the insurance company elects to rebuild or repair, the company may be held liable for damages including the rental value of the property if there is any unreasonable delay in the reinstatement of the property. Such was the effect of the decision in Phila. Fire Association v. Rosenthal, 1 Atl. 303, 108 Pa. 474, 15 Ins. L. J. 658; Henderson v. Sun Mutual Ins. Co. 48 La. Ann. 1031, 20 Sc. 164, 55 Am. St. Report 292; and Home Mutual Ins. Co. v. Garfield, 60 Ill. 124.

But where a reasonable time has not elapsed the company is not liable. See Leonardo v. Phoenix Ass. Co. 2 Rob. (La.) 131; St. Paul F. & M. v. Johnson 77 Ill. 598, 6 Ins. L. J. 434. This, however, is not an extension of the coverage of the policy but is merely a right to sue for damages upon the new contract of repair between the insurance company and the insured.

[10] New York Standard Fire Policy—Insuring clause.

[11] Joyce, *A Treatise on the Law of Insurance of Every Kind*, 1917, 5 vols. Lawyer's Co. Op. Pub. Co., Rochester, N. Y., Vol. II, pp. 1690–1691, Para. 900 and cases cited therein.

[12] Citations to support this point for each type of interruption insurance will be shown later in this chapter.

who has an insurable interest in the property itself may not have an insurable interest to support an interruption policy, and vice versa, separate policies usually are issued to cover the existing interests.

Insurable Value—Interruption Insurance Generally.

While the measure of an insurable interest is the extent to which the insured might be damnified as a result of the destruction of the property out of which the interest arises, the extent to which such an interest may be insured, or the amount of insurance required in order that the insured be fully protected, may be a much larger sum.[13] That the contract may be a contract of indemnity depends not upon the extent to which the interest may be insured, but rather upon the provisions of the contract determining the amount which will be paid in the event of a loss, and will be discussed under that head.[14] It is important, however, that the insured carry sufficient insurance to protect his interest, and to determine this amount (the insurable value) it is necessary to examine all of the possible items which the insured might lose in whole or in part and to evaluate them. It is also important that the amount of insurance be kept within reasonable bounds, for over-insurance is not only expensive to the insured but also undesirable. The amounts of insurance required for adequate coverage vary with the various types of interruption insurances and also with the different policy forms of each type.[15]

Two questions now present themselves. First, which of the various parties interested in the property, the destruction of which will cause a business interruption loss, has the insurable interest required for each of the different forms of interruption insurance, and under what circumstances does such an insurable interest exist? Second, how may the extent of the insurable

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[13] See page 38.
[14] See Chapters 3, 4 and 5.
[15] Policy forms will be considered in this chapter only insofar as it is necessary in determining the insurable value.

value for each class be determined?[16] The various types of interruption insurance will now be considered separately.

Insurable Interest—Rent Insurance[17]

Rent insurance may be defined as "that class of underwriting which offers indemnity or a guarantee to the lessor against loss of rents resulting from fire rendering the property untenantable; or against loss to a tenant, where the lease does not exempt him therefrom, by reason of an obligation to pay rent while the premises, as a result of fire, remain untenantable."[18]

1. *Interest of the Owner Occupant.*

When an owner occupies the property himself it is evident that he has an insurable interest in the rental value[19] of the property for, upon the occurrence of a fire, he loses the use of the property and is obliged to pay rent to secure like premises for his occupancy until such time as the property can be reinstated.

2. *Interest When Premises Are Leased.*

When the property is let to another reference must be had to the lease in order to determine whether the owner, as landlord or lessor, has retained his insurable interest in such rental value, or whether the interest now rests in the lessee or tenant.

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[16] Failure to analyze carefully the insurable interest and insurable value of a risk has caused many of the difficulties which have been experienced with business interruption forms of insurance. The following discussion, therefore, is of more than academic interest.

[17] For numerous cases supporting an insurable interest in rent, see *Corpus Juris*, p. 360.

[18] Joyce, *Opus cit.*, Vol. I, pp. 110–111, Para. 13a, quoting Whitney Estate Co. v. Northern Assurance Co., 155 Cal. 521; 23 LRA (N. S.) 123; 101 Pac. 511.

[19] Distinction is frequently drawn between the terms "rental value" and "rent". When premises are occupied by an owner or held by an owner for rent the term "rental value," the sum for which the premises could be rented or which would be required for the use of like premises, is used to describe his interest. When premises are rented for a stipulated sum the term "rent" is used to describe the interest. This distinction is misleading for, as will be seen later, not only does an owner occupant possess an interest to the full "rental value," but a lessee occupant under a lease providing for the continuance of rent even though the property is destroyed also has an interest to that extent.

(a) Tenant's Interest Under the Common Law Rule.

In the absence of any specific agreement in the lease relating to the rent to be paid for the premises the landlord is entitled to recover from the tenant under an implied contract, the reasonable rental value of the premises.[20] Under the common law both in England[21] and in the United States this liability on the part of the tenant, whether it be under an implied contract to pay a reasonable rent, under an oral agreement to pay a definite rent,[22] or under an express provision contained in the lease of the premises, is unaffected by the fact that the tenant is deprived of the use or beneficial enjoyment of the premises through their damage or destruction by some unforeseen casualty happening without the fault of either the landlord or tenant.[23] This rule is most frequently applied in the case of the total or partial destruction of buildings or improvements on the leased premises by fire, but it applies equally well whatever may be the cause of the destruction.[24] The reason for such a rule lies in the fact that even though the entire premises are totally destroyed the tenant still has the right to the use of the land and, "there remains something out of which, in theory, the rent can issue, however small may be the value of the land as compared with that of the buildings destroyed."[25] Under such circumstances, then, the lessee[26] or tenant has the insurable interest in

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[20] See *American and English Encyclopedia of Law* (2nd Ed.) Vol. 18, p. 269.

[21] *Bunyon on Fire Insurance*, 7th Ed., 1923. C. & E. Layton, London, p. 315.

[22] Tiffany, *Landlord and Tenant*, 1912, 2 Vols., Vol. 1, p. 1192.

[23] *American and English Encyclopedia of Law* (2nd Ed.), Vol. 18, p. 305 and cases cited therein.

Tiffany, *Opus cit.*, Vol. 1, p. 1191 and cases cited therein.

[24] Tiffany, *Opus cit.*, Vol. 1, p. 1191 and cases cited therein. *American and English Encyclopedia of Law* (2nd Ed.) Vol. 18, pp. 306 and 307. Numerous cases are cited for England, Canada, for the United States and for various individual states.

[25] Tiffany, *Opus cit.*, Vol. 1, p. 1196. *American and English Encyclopedia of Law*, Vol. 18, p. 308. But where a building alone, or part of a building, or an apartment is the subject matter of the lease, the total destruction of (not merely the damage to or untenantability of) the subject matter leaves nothing from which the rent may come and the liability of the tenant ceases. This, however, is not true in England. (See Tiffany, *Opus cit.*, Vol. 1, pp. 1196–1197.)

[26] This also applies to a sub-lessee under the same circumstances, and to a guarantor for rent.

the rental value of the property,[27] for his is the loss in case of its destruction.[28]

(b) Criticism of the Common Law Rule.

The common law rule has been severely criticized and in some states has been disapproved.[29] It would seem that the rule inflicts an undue hardship upon the tenant, especially where the major portion of the enjoyment of the premises is derived from the buildings located on the land rather than from the land itself. Further, the landlord obtains the insurance money upon the destruction of the property and is able to rebuild, whereas the tenant, or lessee, is not, nor can he compel the application of such money toward the repair or reconstruction of the property.[30]

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[27] See Heller v. Royal Insurance Co. 133 Pa. St. 152, 177 Pa. St. 262, 35 Atl. 726; Marshall v. Schofield 47 L. T. (N. S.) 406, 31 W. R. 134, 52 L. J. Q. B., 58.—In the former case it was held that a reentry of the landlord to rebuild after a fire released the tenant from liability to pay rent, and though he had agreed to continue to pay rent after the landlord's reentry the insurer was not liable therefor.

Instances where the tenant has an insurable interest in the rental value of the premises are relatively infrequent, for, as will be seen later, the effect of the common law rule is usually avoided.

[28] Whether the landlord (owner) could insure against loss of rents under such circumstances has not been decided. He may desire insurance for the reason that, upon the destruction of the property, the tenant's ability to pay the rent for which he is liable may suffer. Were such insurance obtained the insurance company would be subrogated to the right of the landlord to collect the rent from the tenant. A foresighted landlord may better care for this contingency by including in the lease a requirement to the effect that the tenant carry rent insurance, or, as will be discussed later, by relieving the tenant, in the lease, from liability for rent and insuring his then unquestioned interest himself. Policies were issued prior to 1872 covering the landlord's interest even though the tenant continued liable for rent. This is evident from the subrogation clause found in Griswold, *Fire Underwriters' Textbook*, N. Y., 1827, p. 105, "And the said company shall be subrogated to any remedy which the insured may have against any tenant liable for rent during the period of repair or restoration of the premises, for their reimbursement."

[29] Tiffany, *Opus cit.*, Vol. 1, p. 1193 and cases.

[30] Tiffany, *Opus cit.*, Vol. 1, p. 1194. *American and English Encyclopedia of Law*, Vol. 18, p. 308. While it is generally true that the fact that the owner or landlord receives the proceeds of the insurance on the property does not alter the common law rule with respect to the tenant's liability for rent (see cases cited in Tiffany, p. 1192), in one state the effecting of insurance by the tenant for the benefit of the landlord as required by the lease was held to exclude an inference that the landlord was to be entitled to both the insurance money and the rent. (Whitaker v. Hawley, 25 Kan. 674, 37 Am. Rep. 277.) (See also *American and English Encyclopedia of Law*, Vol. 18, pp. 308–309.) But a tenant was not allowed to show in defense to an action by a landlord for rent, where the tenant claimed a constructive eviction by the landlord's failure to make necessary repairs after a fire, that the landlord collected rent insurance for part of the time for which he sought to recover rent from the tenant. (Brewster v. Silverstein, N. Y. App. Tr. 133 N. Y. Supp. 473.)

There are several reasons, however, for the retention of the rule. The lease may be considered as a sale of the property for a term and, as such, the property is at the lessee's risk just as would be any other property purchased. Hence any loss of use of the property should fall upon him. The lessee, if he so desires, may contract away this liability by requiring specific provision to be made in the lease for the adjustment of, or relief from, rent in the event of the destruction or untenantability of the property which is let. It is also contended that were the lessee to be allowed to terminate a lease upon the occurrence of a fire it would cause him to exercise but little care in protecting the property from loss. This would be especially true where the property had been let under a lease calling for more than the present rental value of the premises.[31] An unscrupulous lessee would, to say the least, be tempted to set fire to the property and thus relieve himself from an onerous, but nevertheless binding, obligation.[32]

(c) Owner's Interest When Common Law Rule Does Not Apply.

Where the common law rule is not followed by the courts,[33] or where statutes have been enacted covering the situation,[34]

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[31] A depreciation in the rental value of the property below the amount of rent called for by the lease may be caused by changed conditions in the locality in which the property is situated, such as changes in the character of the population, the erection of penal or other institutions, the possibility of rerouting of traffic or the establishing of a thoroughfare as a one-way street adversely affecting business, and many similar circumstances. Any such conditions may give rise to a greatly increased moral hazard through the inability of the tenant to continue the payment of rent at the agreed rate, or through the inability of the owners to command the rent upon which they figured.

[32] See Tiffany, *Opus cit.*, Vol. 1, pp. 1193–1195.

[33] See Tiffany, *Opus cit.*, Vol. 1, p. 1193, and *Encycl. of Law*, Vol. 18, pp. 307–308.

[34] See *Encyclopedia of Law*, Vol. 18, p. 308. Tiffany, *opus cit.*, Vol. 1, pp. 1211–1213. The New York Real Property Law of 1896, Section 197, provides as follows: "Where any building which is leased or occupied is destroyed or so injured by the elements, or any other cause as to be untenantable and unfit for occupancy, and no express agreement to the contrary has been made in writing, the lessee or occupant may, if the destruction or injury occurred without his fault or neglect, quit and surrender possession of the leasehold premises, and he is not liable to pay to the lessor or owner rent for the time subsequent to the surrender."

the lessee generally is entitled to an abatement of the rent to be paid when a substantial part of the premises is destroyed without the fault of the lessee,[35] or when he is deprived of the use or enjoyment of the premises by accident or fortuitous events. In some cases termination of the lease by the lessee is permitted;[36] in others rent is merely suspended until the premises are made tenantable again; and in still others surrender of the premises and termination of the lease are conditions precedent to the lessee's obtaining relief from rent.[37] Likewise, the tenant's liability for rent is usually changed and defined by express provisions in the lease. A clause which relieves the tenant from an obligation to restore the building does not, however, have the effect of relieving him from liability for rent.[38] If the tenant is released in any manner from his obligation to pay rent upon the destruction of the premises, the owner or landlord has an insurable interest in the rent which would have been derived from the property had it not been destroyed,[39] and the tenant or lessee has no such interest.[40] Insurance on the landlord's interest in rents is comparatively free from any element of moral hazard for the property is out of his immediate control.

3. *Other Interests.*

An owner in possession of a building which is vacant but which, if it is not destroyed, is likely to be rented has an insurable interest in the rental value of the property. It is necessary,

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[35] And such an abatement is "not limited to the rental value of the part destroyed, but includes any depreciation in the rental value of the balance of the premises." Tiffany, *opus cit.*, Vol. 1, pp. 1202, 1203.

[36] The effect of termination of the lease will be considered later.

[37] See Tiffany, *opus cit.*, Vol. 1, pp. 1217, 1219.

[38] See Tiffany, *opus cit.*, Vol. 1, p. 1202.

[39] Carey v. London Prov. Fire Ins. Co., 33 Hun. (N. Y.) 315. Cushman v. Northwestern Insurance Company, 34 Me. 487. Kane v. Commercial Insurance Company, 8 Johns (N. Y.) 299.

[40] Moving Picture Company of America v. Scottish Union and National Insurance Company. (Pa. Sup. Ct.) 90 Atl. Reporter 642. It was held that a policy insuring a lessee against loss of rents, where the lease relieved him from liability for rent upon the destruction of the property by fire, and where he had sublet to another for the same rent as that which he was paying, was merely a wager for there was no insurable interest to support it. But where a lessee sublets at a profit he can recover the difference between the rent payable to and the rent payable by him. Note 16 L. R. A. (N. S.) 1055.

however, that there be a strong probability that the building will be rented in the near future, for were it not so, the owner would suffer no loss upon the destruction of the property. The moral hazard must be beyond any doubt in order that the insurance should not be prejudiced by the possibility of an unscrupulous owner "selling out" to the insurance company in order to obtain an income from an otherwise losing or profitless investment.

Where a building is in the course of construction and not yet ready for occupancy the owner may have an insurable interest in the probable rental value of the building upon its completion.[41] This interest results from the fact that the destruction of the portion of the property already constructed will delay the completion of the property and the owner will suffer a loss of rents which he otherwise would have received for the period over which its tenantability is delayed. It is again necessary that the insurer satisfy himself as to the probability of the building being rented upon its completion.

Second mortgagees on a manufacturing premises sought to establish an insurable interest in the rents from the property. After having obtained a policy on rents they failed to obtain payment under the policy on the grounds that, "the occupation rent could only be lost to the persons entitled to receive it."[42]

Insurable Value—Rent Insurance.

1. *The Interest Covered.*

The extent to which it may be required that rents be insured in order that the insured be able to obtain complete indemnity depends first upon the particular interest covered. If the interest is that of the owner occupant, or that of the lessee occupant whose liability for rent continues, his interest extends to the full rental value of the premises, which value may be measured by the amount which could have been obtained for the premises at the time of their damage or destruction had they been let to

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[41] See *Weekly Underwriter*, New York, July 30, 1927, p. 233. *National Underwriter*, Chicago, August 18, 1927, p. 16.

[42] Westminster Fire Office v. Glasgow Provident Investment Society, 13 App. Cos. 699.

another, or by the amount which he would be compelled to pay for the use and enjoyment of premises similar in every respect. It is necessary, then, that the one possessing the interest estimate the probable rental value of the premises, giving due consideration to any increases or decreases in such value which may occur during the period over which the policy covers.[43] If, in the course of the policy's term, the insured should find that he has incorrectly estimated the rental value he may supplement the policy with additional insurance or he may cancel a portion of the policy.

If the interest is that of an owner who has let, or of a lessee who has sub-let,[44] the property at a definite rent,[45] the interest extends only to the contracted amount of rent. If there should occur an increase in the rental value of the property it is clear that the loss of the excess of the rental value over the amount of rent for which the property had been let is not the result of the destruction of the premises, for all that would have been obtained by the owner lessor or the sub-letting lessee had the property not been destroyed would have been the definite rent for which the lease provided.[46] While an increase in the rental value of a property is included in the rent insurance policy of an owner-occupant or of a lessee-occupant whose liability for rent continues, and is not covered in the rent insurance policy of an

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[43] As will be seen later (p. 69) this period is not coincident with the term of the policy.

[44] Where the original lease does not relieve the lessee from liability for rent and he sub-lets under a lease in which the sub-lessee is relieved from such liability.

[45] The amount of rent under a lease must be definitely fixed or capable of definite ascertainment. See Tiffany, *opus cit.*, Vol. 1, p. 1046.

[46] By letting property at a flat rent the lessor assumes the risk of an increase in the rental value of the property. If he wishes to avoid this possible loss the rent called for in the lease may be "graded," stipulated rents being provided for various parts of the term of the lease. In this case the lessor's interest extends to the amount of rent contracted for over the period covered at the then-existing "graded" rate. Or the lease could provide for the determination of the rental for subsequent periods by means of revaluation of the property. Here the interest would be measured by the rent prescribed for the period covered based upon the then-existing valuation. Or the rent could be varied by providing that a stipulated minimum rent be paid and in addition a stated percentage of gross sales over a certain amount. In such a case the lessor, in determining the extent of his interest, should estimate the amount of the lessee's sales for the period covered and insure to the amount of rent resulting from such an estimate.

owner who has let or of a lessee who has sublet the property at a definite rent from which the lessee or sub-lessee is relieved upon the destruction of the property, it does not follow that this increase in value does not give rise to an insurable interest. The interest which is created under such circumstances is covered under a different form of insurance,[47] and will be described later.

2. *Gross Rent—Net Rent.*

The insurable value for rent insurance purposes also depends upon whether it is intended to cover gross or net rents. In policies insuring merely on rents there arose the question as to whether the policy covered gross rents or gross rents less the expenses which cease during repairs or reconstruction. The Supreme Courts of two states rendered conflicting decisions. In one case it was held that the loss of rents shall be deemed to be the total amount of rents that would be collected by the insured[48] on the theory that the contract, being ambiguous, should be construed favorably to the insured; that the adoption of net rentals as the basis upon which to determine the amount of a loss would lead to much litigation; and that the policy, in stipulating a method of ascertaining and computing the loss of rent, was analogous to a valued policy. Gross rents are definite and easily ascertained, but, in spite of the contrary view of the court, it is evident that the principle of indemnity is violated in favor of simplicity. If the insured is able to recover the gross rents from his property, and, upon its destruction, can avoid such expenses as light, heat, water, janitor and elevator service charges,[49] he is enabled to profit by the occurrence of the hazard insured against. Such a situation is admittedly undesirable. That the contract covers only net rents, indemnifying the insured for only such actual loss as he suffers, was the view held in a later case.[50]

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[47] Leasehold value insurance, see pp. 38, et seq.

[48] Whitney Estate Company v. Northern Assurance Co. (Cal. Supreme Court). 101 Pacific Reporter 911, 155 Cal. 521, 23 L. R. A. (N. S.) 123, 22 Deitch 382. (June, 1909.)

[49] Expenses which may be avoided upon the destruction of property by fire will be considered in detail later in this chapter. See pp. 58, et seq.

[50] Chronicle Building Company v. N. H. Fire Insurance Co.—94 Southeastern Reporter 1043, 31 Deitch 345. (March, 1918.)

At the present time policies definitely stipulate that such charges and expenses as do not necessarily continue shall be deducted. While recovery is, therefore, limited to the loss of net rents or rental value, it may be desirable for the insured to carry an amount of insurance based upon the gross rents or rental value of the property. Otherwise upon the occurrence of damage to the property which results either in only a portion of the premises being rendered untenantable or in a short period of untenantability the insured would be unable to recover for the full amount of his loss since few or none of the expenses could be discontinued.[51]

3. *Premises Rented or Vacant.*

The insurable value may also depend upon whether the policy is to cover the rental value of the entire premises whether rented or vacant, or whether it is to cover only the rental value of the portions of the premises occupied and rented at the time of the occurrence of the hazard. In the former case insurance should be carried to the full rental value of the entire premises. Since, in the latter case, it is the extent to which the premises are occupied and rented at the time of their damage or destruction which determines the requisite amount of insurance, it is necessary to estimate the probable portion of the premises which will be occupied during the term of the policy. If at any time during the term it is likely that the entire premises will be occupied insurance will be necessary to the extent of the full rental value of the entire premises. But where it is likely that a part of the premises will remain vacant a policy covering the occupied and rented portions only may be reduced to the amount of the rental value of those parts of the premises which will remain occupied.

4. *Length of the Period Used as a Basis.*

Rent insurance policies differ in that the amount of insurance required may be based either upon the rental value "for the time

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[51] The reason for this is that rent insurance policies contain clauses which as will be described later, effectively require insurance to the extent of 100 per cent of the annual amount of the rent which it is sought to recover, and in the case of such partial losses as described above the loss is really a loss of *gross* rents.

that would, with reasonable diligence and dispatch, be required to rebuild and restore the same to a tenantable condition, if totally destroyed," or upon the rental value "per annum."[52] It is this difference in policy forms which accounts for the difference between the insurable value and the extent of an insurable interest. When the amount of insurance required is based upon the time to rebuild or restore the premises the insurable value and the extent of the insurable interest coincide. To determine this amount it is necessary to estimate the length of time which would be required to rebuild the property, including the time necessary to place the contract for repairs.[53] When the policy requires insurance to the amount of the annual rental value this amount is the insurable value but the extent of the insurable interest, the extent to which one might be damnified, may be much less. If, for example, a property could be rebuilt within four months the rents over a four months' period would be the maximum amount which an insured could lose and this would be the extent of his insurable interest.

Insurable Interest—Leasehold Insurance.

Leasehold insurance may be defined as insurance which offers indemnity to a lessee or sublessee against loss of the increased value of his leasehold over the rent which would have been payable under the lease for the remainder of its term, resulting from the cancellation of the lease upon the occurrence of the hazard insured against; or against loss of the increased value of his leasehold over the rent which would have been payable under the lease for the period over which the lease may be suspended upon the occurrence of the hazard insured against; or against loss of the profit of the leasehold for the remainder of its term or for the period of its suspension, where the property has been sub-let at a rental in excess of the rent payable by the insured and where the lease may be cancelled or suspended upon the occurrence of the hazard insured against.

To establish an insurable interest in support of leasehold

[52] See policy provisions. Chapter 3, p. 93, et seq.
[53] Hartford Fire Insurance Company v. Pires, 165 S. W. 565.

insurance policies it is necessary to show first that there has been an increase in the value of the lease over the amount of rent called for by it, and second that this increased value may be lost upon the occurrence of the hazard insured against. A favorable lease, calling for the payment of rent of an amount less than the present rental value of the premises, may be obtained by a lessee driving a shrewd bargain with the lessor, or by the lessor, for any reason, letting the property for less than its actual rental value.

1. *Establishing a Leasehold Value.*

An increase in the value of a lease may be brought about by numerous conditions. Where a property has been leased and the lessee improves the property, the improvements give rise to an increased rental value of the property over the rent called for by the lease. The improvement of transportation facilities or the installation of new transportation facilities may increase the rental value of property in the locality affected. The erection of a bridge improving the access to the location in which the property is situated, or the building of hotels, terminals, theatres or factories in the locality may enhance the rental value of property located favorably in the vicinity. In a residential neighborhood the erection of new dwellings or the improvement of old ones, the removal of undesirable properties such as jails, asylums, and the like, the improvement of streets or the installation of drainage and disposal systems will increase the rental value of affected properties. In business districts the opening of a new street, the shifting of business to the locality, an increase in the population from which its business is drawn, or an improvement in business conditions generally may enhance the value of a lease. Increases in the cost of construction and maintenance or operation of property will necessitate an increase in the rents of property and will contribute to the value of a lease which had been effected on a lower scale of rents.

2. *Leasehold Value and Leasehold Profit Distinguished.*

An increase in the value of the leasehold is of benefit to the lessee in possession at the time the increase occurs. He may

obtain this benefit by continuing in possession and occupying the property, or he may dispose of the lease. If he disposes of the lease to another in return for a bonus the new lessee merely obtains the leasehold value which the original lessee had. But if he disposes of his lease by sub-letting the property to another at the higher rent which can now be obtained, he has converted his leasehold value into a leasehold profit which will accrue to him as he receives the higher rent and is under the obligation of paying only the lower rent called for by his lease. Any further increase in the rental value of the property will be of no benefit to him for he has definitely established his profit and has let the property at a definite rent. The increased rental value will be vested in the present sub-lessee in possession for he is obtaining the use of the property at less than the present value of that use. Thus the premises could be let and sub-let indefinitely, each successive lease establishing a leasehold profit, but the only leasehold value interest which would exist as a result of any future increase in the rental value of the property would be that of the last sub-lessee.

Under what circumstances, then, may this leasehold value or profit be lost? Certainly if the lease may be terminated before the expiration of its term the lessee in possession[54] will be obliged to seek new quarters for which he must pay the increased rent. He suffers a loss, then, of the difference between the rent which he was paying under his lease and the increased rent necessary to obtain similar property for his use for the unexpired term of his lease, and thus possesses an insurable interest.[55] Insurance on this interest is known as leasehold value insurance. If the lessee has sublet the property to another at a higher rent and the leases and sub-leases may be terminated before the expiration of their terms the lessee is deprived of his rental income and suffers a

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[54] In Castellain v. Preston (1883) 11 Q. B. D. 380–400 it was held that even though possession alone is sufficient to give a tenant an insurable interest, his right of occupation under the lease gives him an interest capable of valuation.

[55] See *Richards on Insurance Law*, 1912, 3d Ed., Banks Law Pub. Co., New York, p. 74, Par. 59 and cases cited therein. Also, E. J. Macgillivray. *Insurance Law*, 1912, London, p. 137; Carey v. London Provincial Fire Ins. Co., 33 Hun. 315; Niblo v. North American Fire Ins. Co., 1 Sandf. 551.

loss of the difference between the rent which he was receiving and that which he was paying for the property over the unexpired term of his lease. This interest is insurable[56] and such insurance is known as leasehold profit insurance. When the lease does not terminate, but when liability for rent ceases[57] until such time as the property may be repaired or replaced the lessee in possession or the lessee who has sublet at a profit suffers a loss of his leasehold value or his leasehold profit over the period required for repairs or rebuilding. While such an interest exists, and is insurable, its coverage is only incidental to leasehold insurance policies. The possible loss is small in comparison to that which will result from the termination of the lease, for the loss covers only the period necessary to repair or restore the property instead of the whole remaining period of the lease.

3. *Termination of the Lease.*

(a) Common Law Rule.

In order to establish an insurable interest in support of leasehold insurance policies it was found necessary that the lease be terminated or that rent be suspended upon the happening of the event insured against. Whether the lease may be terminated or rent suspended is determined by reference to stipulations contained in the lease, or, in the absence of such stipulations, by the law of the state under which the lease is governed,[58] or by

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[56] See Lite v. Firemen's Ins. Co., 104 N. Y. Sup. 434, 119 App. Div. 410; Note in Palatine Ins. Co. v. O'Brien in 16 R. L. A. (N. S.) 1055, 193 N. Y. 639.

[57] When liability for rent does not cease the lessee's interest extends to the full rental value of the property, which includes the increased value of the lease, and is covered under a rental value insurance policy.

[58] "The rights of parties in the relationship of landlord and tenant are governed by the law of the place where the demised premises are situated. The place where a contract of letting is to be regarded as having been made has been held to be the place where the lease is delivered although it is signed in another jurisdiction." 35 Corpus Juris 957, quoting cases. "Doubtless, as in the case of executory contracts for the sale of land, leases of real property may be governed by the lex loci contractus or lex loci solutionis, if the question is one as regards which the lex rei sitae is a rule of construction, and not of property; otherwise the lex rei sitae governs, unless the question pertains to

the common law. Under the common law the fact that a lessee continues liable for rent upon the destruction of or injury to the premises involves the view that the tenancy itself still continues.[59] Hence there is no termination of the lease nor suspension of rent and consequently no leasehold interest. When there is "a lease of a building alone, without the land, or of merely certain rooms in or parts of a building, if the building, or the part thereof which is the subject of the lease, is destroyed,[60] it has been generally held in this country that nothing remains from which the rent can issue, and that consequently the liability therefor immediately ceases."[61] Whether the lease is of the building or a part of the building alone is a question of the construction of the lease, and if it is so construed an insurable interest exists.

(b) Statutory Provisions.

In many states statutes have been adopted which partly or wholly relieve the tenant from liability for rent upon the destruction of the building during the term of the lease, or upon its injury to such an extent as to render it unfit for occupancy, or upon failure of the lessor to repair within a reasonable time. In some statutes it is definitely stipulated that the rent shall merely be suspended until repairs are made, and that the lease shall revive thereafter for the remainder of its term; in others it is definitely provided that the lease shall terminate; in still others it is a question of construction of the particular statute as

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the remedy, in which case, of course, the lex fori governs." *Lawyer's Reports Annotated*, 1916 A, p. 1047.

"In general the rights of the parties under the lease are governed by the law of the state in which the demised premises are situated." 35 Corpus Juris 1174, citing—

Galland v. Shubert Theatrical Co., 105 Misc. 185, 172 N. Y. S. 775; Genet v. Delaware & Hudson Canal Co., 13 Misc. 409, 35 N. Y. S. 147; Bowler v. Emery 29 R. I. 310, 70 A 7.

[59] Tiffany, *opus cit.*, Vol. 1, p. 97 and cases cited under notes on p. 1191.

[60] Not merely rendered untenantable. Tiffany, *opus cit.*, Vol. 1, p. 97 and cases cited under notes on p. 1197.

[61] Tiffany, *opus cit.*, Vol. 1, p. 97 and cases cited under notes on p. 1196.

to whether the tenant's relinquishment of the premises terminates the lease.[62]

(c) Provisions of the Lease.

Most frequently the question as to whether rent continues, whether it is suspended, or whether the lease terminates upon the destruction of or damage to the property, is settled definitely by the specific provisions of the lease itself.[63] In any event the lease must be examined for it is only upon the omission from the lease of reference to the above conditions that statutory or common law prevails. When unimproved property is leased and the lessee erects buildings upon the land he can not impose upon the landlord any obligation to compensate him for such improvements, nor has he the right to remove them upon the termination of his tenancy in the absence of particular stipulations in the lease.[64] Consequently a lease of unimproved property will not ordinarily provide for the termination of the lease by the destruction of the premises for which the tenant has paid. While the tenant has an insurable interest in the property itself,[65] and an insurable interest in the rental value of the premises,[66]

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[62] ". . . practically all of the States have passed laws which provide that in case of the destruction of the entire property, the tenant may remove immediately after the destruction and the lease is thereupon terminated." Benson and North, *Real Estate Principles and Practices*, 1924, Prentice-Hall, p. 128.

[63] See *Amer. and Eng. Encyc. of Law*, 2d Ed., Vol. 18, p. 309.

[64] Tiffany, *opus cit.*, Vol. 1, p. 97 and cases cited under notes on p. 1692.

[65] It was held in Laurent v. Chatham Fire Ins. Co., 1 Hall 45, a frequently quoted case, that a lessee may have an insurable interest to the full value of the buildings where he has the right to remove them even though they would be worth much less if removed. And in Fowle et al v. Springfield F. & M. Ins. Co., 122 Mass. 191, 23 Am. Rep. 308, it was held that even though the right to remove the buildings did not exist a lessee had an insurable interest in them to their full value though the lease had only four months to run. As to the lessee's insurable interest in property see:

Hidden v. Slater Mutual Fire Ins. Co., 12 Fed. Case No. 6463, 2 Cliff. 266; Phila. Tool Co. v. British Amer. Ins. Co., 132 Pa. 236; Heller v. Royal Ins. Co., 34 L. R. A. 600, 7 L. R. A. 411.

But where a lessee has merely the right to possess and occupy them for the unexpired term of the lease his interest should be insured as a leasehold interest for it is merely the value of the tenement for occupation for the remainder of the term. Niblo v. North American Fire Ins. Co., 1 Sandf. 551. Carey v. Provincial Fire Ins. Co., 33 Hun. (N. Y.) 315.

[66] For reasons explained before. See pp. 30 and 31.

he has no leasehold interest for rent is not suspended nor is the lease terminated. Where, however, the tenant has contracted to erect buildings or improve the property, whether or not the landlord has agreed to compensate him for them in any way, a provision may appear in the lease providing for the termination of the lease upon their destruction. A leasehold value has been created through the improvement of the property, and the possibility of the termination of the lease imposes upon the lessee the risk of loss of this leasehold value for the remainder of his term in the lease. When long term leases, for 99 years or more, are entered into the lease does not provide for its termination upon the destruction of the property, nor does it allow the lessee to avoid the payment of rent during the period required for rebuilding or for repairs. That this should be the case is readily seen, for the lessee is to all practical intent in virtually the same position as an owner. Under such a long term lease he has purchased ownership for the term and is subject to the same risks as an owner. While he has no insurable interest in a leasehold value, he has, usually, an insurable interest in the property, since the burden is upon him to replace the property destroyed, and an interest in the rental value of the property because of his continuing liability for rent. Excluding short term leases of one or two years duration, for in these the possibility of an increase in the value of the lease is slight and even though terminated by the destruction of the property the loss would be of short duration, the large majority of other leases provide the lessee with an insurable interest in any leasehold value or profit which might arise or which may have arisen. The lessee considers in advance that if the property is injured or destroyed he will be deprived of its use and enjoyment. He desires, then, relief from rent. Under such circumstances, too, the lessor desires to reenter the premises in order to rebuild or repair. Having given the lessee relief from rent the lessor desires to terminate the lease. Whether a stipulation in the lease to the effect that liability for rent shall cease upon the destruction of the property has the effect of terminating the lease, is a question of construction

of the particular stipulation.[67] Since it is uncertain, and since the cessation of liability for rent gives only an insurable interest limited to the period required for the reinstatement of the property, the lease may, and usually does, provide specifically for its termination under certain circumstances. While any possibility of termination of the lease on the part of the lessor[68] as a result of the hazard insured against is sufficient to establish a leasehold interest, the variation in the clauses covering this situation are significant.[69] The clause in the lease out of which the insurable interest arises will be copied into the leasehold insurance policy. This clause may provide that the lessor may terminate the lease or that the lease shall be terminated automatically when the building is totally destroyed, or when the damage to the building amounts to a given percentage of its value, or if it be so damaged that the landlord shall decide to rebuild or shall decide not to repair, or if the building be rendered untenantable or uninhabitable by the stipulated hazard or hazards.[70]

Insurable Value—Leasehold Interests.

1. *Leasehold Profit.*

First the insurable value of a leasehold profit may be considered. Here the lessee has an interest amounting to the difference between the rent at which he has sublet the property and that which he is paying (plus any additional expenses) under his lease, for the remainder of the term of his lease. In

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[67] Tiffany, *opus cit.*, Vol. 1, pp. 97, 98, and cases cited under notes on p. 1206.

[68] A lessee would terminate a lease, were its termination at his option, only if the lease were unprofitable and, hence, there would be no loss of leasehold value. If the lessor has the privilege of terminating a lease he will do so if the lease has increased in value for, by its termination, he will be able to relet the property at its higher rental value. It is only when the lessor cancels the lease that the lessee suffers a loss.

[69] Especially because they determine the degree of hazard involved and, consequently, the rate for this form of insurance.

[70] Where it is merely provided that rent shall be suspended until the building is rebuilt, the election of the landlord not to rebuild has been held to have the effect of terminating the tenancy. Tiffany, Vol. 1, p. 1206, quoting, Schmidt v. Pettit, 8 D. C. (1 McArthur) 179; Snook & Austin Furniture Co. v. Steiner, 117 Ga. 363, 43 S. E. 775.

illustration, suppose that a lessee, under a twenty-year lease[71] calling for rent at the rate of $200 per month and providing for its termination upon the destruction of the property by fire, after five years have passed, has sublet the property at the rate of $300 per month. In this latter lease he has agreed to furnish light, heat and water, none of which are provided for in his original lease. These expenses amount to an average of $25 per month. His leasehold profit is, then, the difference between $275, his monthly net income from the property, and $200, his monthly rent, or $75 per month. Since his lease has 15 years, or 180 months, still to run and his profit is at the rate of $75 per month net, he will realize a leasehold profit of 180 times $75, or $13,500,[72] for which amount insurance may be required. It is evident, however, that $13,500 is not the present value of his profit. He will receive $75 profit per month over a period of 180 months, but since the payments are deferred from one to one hundred and eighty months hence, these payments must be discounted to their present value. If, for example, he were given $72.11 now he would, at 4 per cent interest, have $75 twelve months hence. The present value of the twelfth payment of rent is, therefore, only $72.11. Likewise each payment will be discounted for the period of its deferment at the rate of 4 per cent and the sum of these discounted values for the 180 months, $10,190.50, is the present value of the lessee's leasehold profit.[73] Were he to be given that sum now, by investing it at 4 per cent compounded annually, he could withdraw

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[71] Whether the lease is a 20-year lease or one which is renewable at the option of the insured for a total of 20 years makes no difference.

[72] If the original lease were renewable at graduated rates, say $200 per month for the ensuing five years, $250 per month for the five years then following, and $300 per month the last five years, the leasehold profit would be $75 per month for 60 months, and $25 per month for 60 months. As yet the lease shows no profit for the last five years of its term.

If the lease provided for rent for subsequent periods to be determined by a revaluation of the property the lessee could sublet for only the term until the next revaluation was to take place, or if he sublet for the entire period he would only sublet with the condition that the rent under this lease be also redetermined. In any event the only leasehold profit which could be established would be that accruing for the remainder of the term till the next revaluation.

[73] Tables appear in the policies from which this amount can be quickly determined.

$75 each month for 180 months before it would be entirely depleted.

As has been stated before, the policy may be written on the basis of the $13,500 gross interest of the insured lessee, but provision is made that in the event of a loss, recovery can be had for only the actual loss sustained as determined by discounting the future rent payments for the unexpired term of the lease from the date of the fire.[74] On the other hand, the policy may be written on the basis of the net leasehold interest of $10,190.50, which then becomes the insurable value.[75]

2. *Leasehold Value.*

The insurable value of a leasehold value interest is of the same nature as that of a leasehold profit except for the fact that the increase in the value of the lease has not been definitely established by the sub-letting of the property at the higher rent. Here the lessee, instead of having sublet the property in whole or in part, is occupying it himself. It is necessary, then, to appraise the present net rental value of the property under the same conditions as those of the lease involved.[76] The difference between this rental value and the actual rental payable under the lease for its unexpired term,[77] undiscounted or discounted

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[74] Loss settlements will be considered in a later chapter. See p. 124 et seq.

[75] A comparison and criticism of the different forms of leasehold interest policies is deferred for a later chapter. See p. 118–122.

[76] If a lease has fifteen years still to run the present net rental value would be determined on the basis of a similar lease for a fifteen year term. This automatically considers the probable continuation of an enhanced rental value, for the rent which one would be willing to pay for a fifteen year lease is determined not only by the rental value of the property now, but also by the probable rental value over the entire term.

[77] That a tenant for life has an insurable interest is well established. But such insurance is usually written on the building covering the interest of the insured as a life tenant. "The fact that the policy in terms covers the building and does not specify the plaintiff's interest is immaterial. The company knew the facts, and, independent of that, in the absence of any specific inquiry on the part of the insurers, or express stipulation in the policy, no particular description of the insurable interest is necessary." Gilman v. Dwelling House Ins. Co., 81 Me 488; 17 Atl. 544; and cases cited. Getchell v. Mercantile & Manufacturers Mutual Fire Ins. Co., 42 L. R. A. (N. S.) 135; 83 Atl. 801. In this latter case, and in Schaefer v. Anchor Mutual Fire Ins. Co., 133 Io. 205; 100 N. W. 857; 110 N. W. 470, the recovery of the insured was held to be limited to the difference between the present rental value of the property and the rental cost to the tenant "for the remainder of the term, such term to be computed from the life tables and other material evidence."

as the case may be, becomes the insurable value.[78] The same method is followed for its determination as was followed in determining the insurable value of a leasehold profit interest, merely substituting the amount at which the net rental value has been appraised in place of the $275 actual monthly net income from the property. Where a lessee occupies a portion of the property himself and sublets the remainder at advanced rents he has both a leasehold value and a leasehold profit, the insurable value being merely the sum of the two insurable values considered separately.

If a lessee has sublet the property at a profit but for only a portion of the remaining term under his lease he has a leasehold profit interest for only the remaining term of the sublease. He may have a leasehold value interest for the remainder of his term after the expiration of the sublease, provided that the rental value of the premises is greater now than the rent payable under his lease. The insurable value will be the sum of the separate values. If there should be an increase in the rental value of the property after some further time has passed, it has been stated elsewhere that the lessee who has sublet has no interest in this increased value of his lease. But since he has now sublet for only a portion of the remaining term of his lease and consequently is possessed of a leasehold value interest for the remainder of his term beyond the termination of the sublease, he has an interest in this increased value for the period over which his leasehold value interest extends. To cover this interest it is necessary for him to supplement the insurance taken out before the later increase occurred. This, naturally, is also the case where the lessee possessed solely a leasehold value interest. The amount of the additional insurable value is the difference between the present rental value of the property and the amount of rental value up to which insurance had already been taken ($275 per month in the illustration) for the period over which the leasehold value interest extends.

An existing leasehold value, but not a leasehold profit, may be

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[78] But if a lease provides that it may be cancelled by the lessor upon the payment of a stipulated sum, this sum is the limit of the leasehold value.

reduced by a decline in the rental value of the property. Since the amount of the insurable value decreases an adjustment of the amount of insurance may be effected.

Insurable Interest—Use and Occupancy Insurance.

Use and Occupancy insurance may be defined as insurance which offers indemnity for the loss, resulting from the interruption of business caused by damage to or destruction of the specifically described property by the hazard or hazards insured against, of net profit and such fixed charges and expenses as must necessarily continue during the period over which the interruption extends.

While use and occupancy insurance has been judicially defined[79] the definition was one arising out of a valued policy considerably different from the forms in use at the present time and is not particularly lucid. It is worthy of consideration, nevertheless, for it illustrates the failure of the term to describe the coverage to which it is applied. "Use and occupancy, as terms of insurance, may assume, within their general scope, the expectation of profits and earnings derivable from property, but the terms appear to have a broader significance as to the subject of insurance, and to apply to the status of the property, and to its continued availability to the owner for any purpose to which he may be able to devote it . . . Insurance on 'use and occupancy' evidently relates to the business use of which the property is capable in its existing condition." This definition of the court is as indefinite as it seemed to consider the policy which it sought to define. The loss of use or occupation of property can not be repaired by insurance. It is the loss of profits and continuing expenses which results from the loss of the use or occupation of the property that the insurance is designed to cover. The term business interruption insurance has been applied without modification to this class of insurance, but, while somewhat more descriptive, it is objectionable on the same grounds and also

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[79] Michael v. Prussian National Ins. Co. (Ct. of Appeals N. Y.) 1902. 171 N. Y. 25; 67 N. E. 810. See also Tannenbaum v. Simon, 81 N. Y. Supreme Ct. 655.

because of the fact that it connotes the coverage of many losses which are not included within the policy. The term is better applied in the sense in which it has been used herein, to denote the whole range of insurances indemnifying for business interruption losses of whatever form. Terminology in any field should be in as close conformity with popular usage as is possible without the sacrifice of accuracy or descriptiveness. Unfortunately accounting terminology is lacking in uniformity so a precise term to cover the idea of the loss of net profits and of expenses which continue during an interruption of business is difficult to find. The terms revenue, income, earnings and profit are used interchangeably or synonymously. In popular usage, however, earnings is a somewhat more restricted term than revenue or income, and is more comprehensive than profit. In view of the fact that the policies also expressly provide that continuing expenses are covered only to the extent to which they would have been earned, it appears that the term, earnings, more nearly expresses the idea of what this form covers than does any of the others. While no distinction has been drawn between avoidable expenses and unavoidable expenses this is not objectionable for expenses which are discontinued need no earnings to support them. Since a suspension of business causes a loss of earnings which would have accrued in the future, it is against the loss of these *prospective* earnings that the policies insure. To include within the title of this form of insurance the nature of the hazard insured against would make it unwieldy. It is also unnecessary. The most descriptive term, with the least sacrifice of accuracy and the closest conformity to popular usage, is "Insurance of Prospective Earnings."[80]

That there exists an insurable interest in the profits and continuing expenses of a business was established long before the origin of use and occupancy insurance,[81] when attempts were made to recover for such losses under the direct damage fire insurance policy. Since its origin, many forms of use and oc-

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[80] The established term, "Use and Occupancy Insurance," however, will be adhered to throughout this treatise.

[81] See Wright v. Pole, quoted in Chapter 1, p. 18.

cupancy insurance policies have reached the courts and have been upheld, evidencing the presence of an insurable interest.[82] The nature of this interest has been implied in the preceding paragraphs, but may be referred to again. Upon the destruction of property, be it in the form of buildings, machinery, equipment or stock, earnings of a going business dependent upon the continued existence of the property depreciate. Such depreciation in the earnings continues until the property can be restored to its original condition.[83] In the meantime there are certain expenses which, in spite of the forced total or partial suspension of business, can not be avoided entirely, if at all. The continuing liability of the business for such expenses without an income from which to meet them, and its inability to secure the profit which it had been deriving from the use of the specified property which has been destroyed or damaged, cause the business to suffer a loss as a result of its destruction. Thus the tests of an insurable interest are fulfilled.

The existing insurable interest is vested in the business, the profits and continuing expenses of which are to be insured. The question arises as to the relationship between the business and the particular property the destruction of which will bring about the loss. The destruction of a building will result in a use and occupancy loss to the business occupying the building, be it owner or tenant. It is occupancy, rather than ownership, which is essential to the possession of an insurable interest. But even occupancy is not essential under a less usual form of use and occupancy insurance which protects a business against loss resulting from the destruction of the property of another

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[82] Among the leading cases are the following: Michael v. Prussian National Ins. Co., 171 N. Y. 25; 63 N. E. 810. Tannenbaum v. Simon, 40 Misc. Rep. 174; 81 N. Y. Supp. 655. Nusbaum v. Hartford Fire Ins. Co., 120 Atl. Rep. 481. Jacksonville Oil Mills v. Globe & Rutgers Fire Ins. Co., 3 Fed. Rep. (2nd) 1006. Tannenbaum v. Freundlich, 81 N. Y. Supp. 292, 39 Misc. Rep. 819. Wilson & Toomer Fertilizer Co. v. Automobile Ins. Co., 283 Fed. Rep. 501. O'Brien v. North River Ins. Co., 212 Fed. Rep. 102. Grand Pacific Hotel Co. v. Mich. Comm'l Ins. Co., 90 N. E. 244. Chatfield v. Aetna, 71 App. Div. 164; 75 N. Y. Supp. 620.

[83] This is the theory upon which use and occupancy insurance is based. It will be seen later that it is subject to some criticism. See Chapter 4, pp. 154–155.

concern upon which it is dependent for a supply of its materials or for power, or upon which it depends for an outlet for its product. For example, a manufacturer of automobiles does not manufacture the bodies for his cars but has contracted for them with a body manufacturer. If the plant of the body manufacturer is destroyed the business of the automobile manufacturer suffers a loss of "prospective earnings"[84] because of the interruption to its business until bodies of the necessary specifications can be produced again. The insurance against a loss of this nature is known as contingent or contributing use and occupancy insurance. Usually, however, the occupant of the premises has the sole insurable interest. With respect to the machinery, equipment and stock, ownership is again unessential. Machinery or equipment may be hired and its use paid for at a stipulated rate or royalty. It is the right to the use of the property rather than ownership which allocates the insurable interest.

Insurable Value—Use and Occupancy Insurance.[85]

Use and occupancy insurance is written upon the basis of an annual value rather than upon that for the period which would be required to replace the damaged or destroyed property, except when such period would be in excess of one year. In this latter case insurance is required in an amount equal to the use and occupancy value for this longer period and the conditions of the policy, as will be seen later,[86] are adjusted accordingly. In cases in which the property can be replaced in less than a year we have again, as in certain of the rent insurance forms, the requirement of an amount of insurance in excess of the maximum amount which could be recovered for a total loss since such a loss would extend over a period less than one year.[87]

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[84] The ineptness of the term "use and occupancy" is apparent.

[85] The following discussion applies to all forms of use and occupancy insurance except the coinsurance forms. The exceptions presented by these forms will be developed in Chapter 4, pp. 168–172 where the various forms are considered.

[86] See Chapter 4, p. 159.

[87] For a criticism of this plan see pp. 83–84; 106–107; 163–164.

1. Items Contributing to the Use and Occupancy Value.

As an approach to the problem of determining the annual use and occupancy value it is necessary to ascertain and analyze the items covered by the insurance. The policies cover, "the actual loss sustained consisting of: I. Net profits on the business which is thereby prevented; II. Such fixed charges and expenses as must necessarily continue during a total or partial suspension of business, to the extent only that such fixed charges and expenses would have been earned had no fire occurred; III. Such expenses as are necessarily incurred for the purpose of reducing the loss under this policy; for not exceeding such length of time, commencing with the date of the fire and not limited by the date of expiration of this policy, as shall be required with the exercise of due diligence and despatch to rebuild, repair or replace such part of said building(s) and machinery and equipment . . . as may be destroyed or damaged . . . "

(a) Net Profit.

The first item which will be affected by a suspension of business will be net profits. A business suspended for less than a year, being obliged to continue the payment of all of its unavoidable expenses before it can appropriate for itself any of the earnings during the part of the year preceding the suspension or during the remaining part of the year subsequent to the suspension, would find its resulting loss reflected in a reduction of its net profit at the end of the year. If the expenses continuing during the suspension were not in excess of the annual net profit of the concern the loss would be solely a loss of profit, for without use and occupancy insurance the earnings of the business would have been sufficient to cover the continuing expenses but insufficient to produce the usual net profit. It is not until the loss of earnings exceeds the amount of the annual net profit that the continuing expenses are jeopardized if there is no insurance. The first item, then, which merits attention is the item of net profits.

The term "net profit" has been variously defined.[88] From an

[88] R. H. Montgomery, *Auditing*, 2nd Ed., 1920, pp. 203–206.

accounting standpoint "The net profit of a business is the surplus remaining from the earnings after providing for all costs, expenses, and reserves for accrued or probable losses."[89] Essentially this same definition has been approved by the courts.[90] With certain elaborations, it may be adopted for use and occupancy insurance purposes. It must be stated definitely, however, that the term "earnings" is intended to include only income from operations. Since, upon the destruction of the property, other income, such as that derived from the investments or rent received for other property owned by the business, will not be discontinued, and since such income is not attributable to the "use and occupancy" of the property specified by the insurance, it is not a proper subject for coverage.[91] The situation may also arise where a business is occupying a property under a long term lease which has appreciated in value and which may be cancelled upon the destruction of the property. In this case there is a use and occupancy insurable interest and also a leasehold value insurable interest. Such a lease would permit a business to show a larger net profit than would be the case were it necessary to pay the present rental value for its property. This additional net profit should be equally as uninsurable under a use and occupancy policy[92] as is income other than

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[89] *Ibid.*, p. 205.

[90] Warren v. King, 108 U. S. 389.

[91] Appreciation of the assets of a business, if carried by the business into its profit account, should also be excluded in determining the net profit. Some illustrations of the determination of net profit for use and occupancy purposes issued by certain insurance companies have erroneously included the item "Income from other Sources" or "Additions to Income." The only justification for this is where the other income is derived from the property specified in the policy, for example rent from a portion of the property which is also occupied by the business. Such an item, solely for the sake of convenience, may be included in the use and occupancy policy though it does not represent a profit from the operation of the particular business of the insured and is covered better under a separate rent insurance policy. This applies as well to profits realized from the sale of assets, or to any other unusual income.

[92] The policy states that "the insured shall not be entitled to compensation on account of loss which may be occasioned . . . by the suspension, lapse or cancellation of any license or lease." This clause, however, is intended only to prevent the extension of the period of indemnity under the policy. It is doubtful whether a company would not pay the full loss of profit for the period of suspension including that resulting from the favorable rent under the lease provided there was sufficient insurance carried. There has been no judicial interpretation of the policy on this point.

that from operations, though such profit could be attributed to the use and occupancy of the specific premises covered by the policy. It is desirable for the business to insure this interest under a leasehold insurance policy, for even though the use and occupancy policy were to cover the additional net profit represented by the annual leasehold value it would only cover its loss for the period required to replace the property and not for the remaining term of the lease.

The net profit which it is desired to cover by insurance is the profit which will probably be realized during the ensuing year. Use and occupancy insurance deals with the future. It insures now against the possible loss of a profit which it is expected will be earned if the destruction of the property does not interfere. Its amount must therefore be estimated. Exact forecasting of the profit of a business for the ensuing year is extremely difficult, if not impossible. Usually an analysis will be made of the income account of the business for the preceding year and estimates then will be prepared for the coming year. Business budgets have been adopted by some concerns for the control of expenditures and the planning of their financial affairs in the future.[93] The same principles applicable to the preparation of budgets are applicable to the preparation of an estimate of the use and occupancy value. Having examined all of the pertinent information available an estimate of the net sales of the business for the coming year will be made. The costs of the estimated sales, selling expenses, administrative expenses and fixed charges will have been reckoned. Deduction of the sum of the latter from the estimated net sales gives the probable net profit of the business, exclusive of other income, for the period under consideration. This amount is a part of the use and occupancy value of the business.

(b) Continuing Expenses.

The effect of a suspension of business would be evidenced next through the inability of the business to produce earnings

[93] See the *Financial Handbook*, Ronald Press, R. H. Montgomery, Editor, Section 4, pp. 254–289 on Budgets.

sufficient to cover the expenses, including fixed charges, which continue during the suspension. While the actual outlay for a fixed charge may have been incurred prior to the suspension the burden of that fixed charge is distributed over the entire year and, by its nature, is to constitute a fixed charge on the earnings for the whole period. It is not the actual payment of expenses which the use and occupancy insurance policy is intended to cover, but rather the loss of the earnings out of which such expenses would have been met. Since certain expenses, which would have constituted a charge against the earnings which would have been realized during the period over which the business is suspended, may be avoided during a suspension, the test as to whether or not a particular expense item is included within the use and occupancy value is whether or not the item will continue as a charge against the business over the period of its interruption. The extent to which a continuing expense contributes to the use and occupancy value is the extent to which such an expense continues. Expenses are either fixed and unavoidable, partly avoidable, or wholly avoidable. Different items of expense will now be considered from this viewpoint.

(i) Wholly Unavoidable Expenses.

Fixed charges, since they continue unreduced during a suspension of business, will be insurable to their full amount for the year. Interest on the indebtedness of the business constitutes one of these fixed charges which can not be earned while the business is interrupted. Directors' fees, salaries of executives, superintendents, foremen, employees under contract and other employees whom it would be necessary to retain whether or not the business is suspended will continue. Charges under non-cancellable contracts for light, heat or power, for advertising, for legal or other professional services, or for royalties are of the same nature. With the exception of premiums for insurance against loss resulting from other hazards to which the property specified in the use and occupancy policy is subject, and those premiums which are based upon the payroll or upon any other item which may be diminished during an interruption of business,

insurance premiums of the business are unavoidable.[94] Automobile public liability and property damage insurance premiums are ordinarily of this class.

Fire insurance premiums and premiums for the amount of use and occupancy insurance finally decided upon are insurable for the reason that, while paid in advance, they are a charge against the period over which the interruption extends, and because no refund of premium can be obtained if the loss is total. If the loss is only a partial loss the insured needs his insurance to protect against further loss and its expense therefore continues. The cost of life insurance on the lives of executives and employees should also be included. Taxes present only a slightly different problem. While a tax may be paid in advance it is a charge over the entire operating period. It would seem, however, that taxes such as income or profit taxes should be uninsurable, for the reduction in income or profit resulting from an interruption of the business would effect a reduction in the tax.[95] Without insurance this would be true. But the purpose of use and occupancy insurance is to make good this loss of income or profits, and whether or not the tax may be reduced as a result of the suspension of business depends upon whether or not the proceeds of use and occupancy insurance constitute taxable income. The United States Board of Tax Appeals had this specific point brought before it for decision and held that such proceeds were to be so considered.[96] Since the tax can not be reduced, and since an interruption will prevent its being earned, it constitutes a proper subject for coverage. Property taxes, license fees and the like are subject to the same reasoning. Rents which continue in spite of the interruption, whether for the destroyed property or for branch offices which are forced to suspend operations as a result of the suspension at the home office, also add to the use and occupancy value of the business and are

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[94] The premiums which are excepted here are generally insurable for they will probably continue in part. See pp. 60–61.

[95] This is the position of several writers on use and occupancy insurance. See W. M. Johnson, *Use and Occupancy Insurance*, pamphlet—Improved Risk Mutuals, New York (1928), p. 4.

[96] Appeal of the International Boiler Works Company. Docket No. 2322. Decided January 12, 1926.

properly insurable as such. This applies equally well to the rental of equipment. While liability for rent of the property, the damage to which will cause the interruption, might also have been covered by a rent insurance contract it is preferable to include it within the use and occupancy insurance. If both forms of insurance are carried provision appears in the contract to prevent double payment.[97]

Trade association dues, memberships and subscriptions, the expense of credit information services and the like continue. Donations or contributions to welfare work, hospitals or recreation grounds are expenses which are distributed over the whole income period and constitute a charge against the earnings of a period during which the business is suspended. Had they not been incurred, or were they not to be incurred, the net profit of the business would be increased and as such would be insurable. The actual or prospective incurring of such expenses reduces the insurable net profit but increases the continuing expenses. Viewed either way the suspension of business causes a loss of earnings which loss is insurable whether the earnings were to contribute to profit or to the expense of donations and contributions.

(ii) Partly Avoidable Expenses.

The next class of expenses to be considered includes those which may be discontinued in part during an interruption. It is evident now that the extent to which certain expenses may be avoided varies with the nature of the business under consideration. It will also depend upon the nature of the interruption. The expenses thus far considered were those which usually would continue in full regardless of the extent of the interruption. In considering the expenses which may be discontinued in part judgment must be exercised in determining the extent to which they shall be insured. If the business desires complete coverage for a suspension of short duration it will find it necessary to carry insurance to the full annual amount of the expenses which can not be avoided during such a short suspension, even

[97] To be discussed later. See p. 160.

though they might be avoided to varying degrees if the interruption were total and lasted over the entire period necessary to replace the destroyed property. In illustration, consider a mercantile establishment with a force of clerks whose salaries amount to $52,000 per year. A fire occurs which necessitates a suspension of business for two weeks. The business would hardly consider it advisable to discontinue the payment of salaries for this two-week period if for no other reason than that the training of new clerks would probably cost more than the amount of salaries necessary to retain those already employed. Since insurance must be carried to the extent of the full annual value of any item for which recovery is sought, the $2000 which the employer pays over this period could not be recovered under his use and occupancy insurance policies unless the whole $52,000 had been included in the insurable value.[98] Whether or not the carrying of $52,000 extra insurance is worth while, if the employer figures that two weeks is the maximum period over which he would retain his clerks at a cost of $2,000, is a matter of judgment in each particular case.

During a suspension of business depreciation continues upon the undamaged portion of the property, but since the damaged portions of the property are to be reinstated in their condition as of the time of the fire the depreciation on these items is avoided. Since it is impossible to estimate the extent of damage which will be done by a fire it is impossible to forecast the amount of depreciation which will be avoided.[99] Usually the entire amount of depreciation will be considered as a part of the use and occupancy value. The exact rate of depreciation on the various buildings, machinery and equipment of a business is of little or no consequence. It does not matter whether or not a reserve for depreciation is set up by the company. If depreciation

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[98] An exception to this statement will be noted later when the various use and occupancy forms are discussed. See pp. 168–172.

[99] Depreciation on machinery or equipment may also be considered as a variable expense for a machine depreciates more rapidly the harder it is used. The difference in degree of depreciation during an interruption, the severity of which is impossible to foretell, and depreciation during the normal operation of the business, can not be measured, and may be disregarded in determining the contribution of depreciation to the use and occupancy value.

is not deducted in determining the net profit then a larger net profit appears and is insurable but depreciation in addition to this is uninsurable. If depreciation is deducted in determining the net profit then a smaller net profit is insurable and the depreciation item is insurable as well.[100] In other words, since there is no actual outlay it makes no difference whether the lost earnings would have been devoted to net profit alone or to both depreciation and net profit. The important point is that the *earnings* are lost. This same reasoning shows the unimportance of considering whether or not interest on the capital of the owners of a business, salaries of the owners, rental value of the property occupied and owned by the business, or dividends guaranteed on its preferred stock should be included as continuing expenses, for if they are not so included they permit the inclusion of a larger net profit. The cost of telephone service will continue at the minimum rate and is a proper addition to the insurable value to that extent only. The expense of maintaining watchmen may continue in full, as may the salaries of salesmen. Traveling expenses, however, may be avoided to some extent. Expenses of branch offices may be discontinued in whole or in part depending upon the extent of the interruption to business necessitated by the destruction of or damage to the property covered. Here again judgment must be exercised in the individual case. Under the heading of unavoidable fixed charges insurance premiums were referred to.[101] It was implied that certain of the premiums could be avoided during the suspension. Upon the damage to the property by fire, the tornado, sprinkler leakage, explosion or earthquake insurance policies and the use and occupancy policies against such hazards could be reduced in amount and a return of part of the premium obtained until

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[100] Reserves for obsolescence are subject to the same analysis as are depreciation reserves, but reserves set up for depletion of assets are not. Depletion of an asset is directly proportional to the degree of operation of the business and as such is wholly avoidable during a period of total suspension regardless of its length.

[101] See pp. 56 and 57.

the property and operations are reinstated. Employer's liability and workmen's compensation insurance premiums, being based upon the payroll of the business, may be diminished as a result of the reduction in the payroll during the interruption. Other insurance policies, rendered unnecessary after a fire, may be cancelled in whole or in part and the premiums saved. Thus a part of this expense could be avoided, but it is impossible to foretell to what extent. It may be desirable, therefore, to provide for the possible necessity of the continuance of all insurance premiums in full by including them to their full amount in the use and occupancy value.

(iii) Additional Expenses Incurred.

While the policy also covers "such expenses as are necessarily incurred for the purpose of reducing the loss under this policy" additional insurance need not be provided to care for this item.[102] An additional expense can not be incurred and the insurance company be held liable for it unless the reduction in the amount of the loss exceeds the additional expense. As a result, the liability of the company for the total of the reduced loss and the additional expense incurred will not exceed the maximum liability under the policy. In other words, the policy is already sufficiently large in amount to cover any additional expenses for which the company could be held liable if sufficient insurance is carried to cover the maximum loss of net profit and continuing expenses.

2. *Determining the Insurable Value.*

The insurable value for use and occupancy insurance is, therefore, the sum of the estimates of the annual net profit and of the continuing expenses for the ensuing year, determined in accordance with the principles expressed in the preceding paragraphs. Another method of determining this insurable value, but one which does not follow the items as they are specified in the policy, can now be found. The net profit of a

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[102] Such expenses will be considered under loss adjustments. See pp. 175-176.

concern (as determined before) plus all expenses, regardless of whether or not they continue, equals its gross profit. Since the insurable value equals the net profit plus continuing expenses it must also be equal to the gross profit minus the expenses which are avoidable.[103] This method brings to the surface a possibility which has thus far been neglected. If the business is being conducted at a loss not only has it no profit to insure, but it can insure only the amount of the continuing expenses which would have been earned. Under the latter method of finding the insurable value this amount is obtained directly. Under the former method, saying that the insurable value is the sum of the net profit and continuing expenses, one might conclude erroneously that the fact that the business is suffering a loss means only that there is no net profit to insure and that the insurable value is, therefore, the full amount of the continuing expenses without deducting the amount of the loss. The first method should be modified, then, by the statement that it applies only if the business is producing a profit, or, if the business is suffering a loss, by considering "net profit" as a negative quantity. If the business is suffering a loss the insurable value is the continuing expenses less the estimated amount of the loss.

If, after having determined the insurable value, insurance to this amount is taken, and, during the course of the term of the policy, conditions so change that a larger or smaller loss of earnings could be anticipated for the ensuing year, the amount of insurance should now be adjusted by the addition of or cancellation of the amount of the difference between the insurance now existing and the new estimate. Since the policy would cover an interruption of a year's duration even though the interruption did not begin until the last day of the policy term, the possible necessity of revising the estimate of the insurable value throughout the policy term is apparent.

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[103] Net profit + All expenses = Gross profit.
Net profit + (Unavoidable expenses + Avoidable expenses) = Gross profit.
Net profit + Unavoidable expenses = Gross profit − Avoidable expenses.
Since net profit + unavoidable expenses = Insurable Value
Therefore, Gross profit − Avoidable expenses = Insurable Value.

Insurable Interest—Profits and Commissions Insurance.

Profits and commissions insurance may be defined as insurance which protects against the loss of profits or of commissions which would have been realized from the sale of goods, but which can not be realized upon their destruction or damage.

Direct damage insurance policies usually limit the amount which an insured may recover to the actual cash value of the goods at the time of the loss. This cash value, it is also specified, is not to exceed the cost to repair or replace the property within a reasonable time. The cost of replacement for a merchant will not be the same as that for a manufacturer, the merchant's cost including the profit of the manufacturer but not his own. The manufacturer's cost of replacement will generally be measured by the actual cost to him of reproducing the goods.[104] While the amount which may be recovered upon the destruction of goods varies with the interest insured, it does not include profits.[105] Thus, the market value, which would include whatever profit a manufacturer of the goods could realize from their sale, can not be used as the basis for determining the amount of his damages.[106] A market value clause may be used on policies covering "leaf tobacco, hides or leather in tanneries, crude petroleum stock at oil refineries, grain, lumber, or whiskey

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[104] But in Phillips v. Home Insurance Co., 112 N. Y. Supp. 769, it was held that upon the destruction of straw hats at a time when it would be impossible to replace them in time for the coming season's trade, the measure of damages was to be the price at which the hats had been contracted to be sold by the manufacturer, regardless of their cost of replacement. There was, however, a dissenting opinion which is in accord with the usual rule. Other cases to the same effect are, Mitchell v. St. Paul German Fire Ins. Co., 92 Mich. 594; Parrish v. Virginia F. & M. Ins. Co., 20 Ins. L. J. 95; Frick v. United Ins. Co., 218 Pa. 409, 67 Atl. 743. In this latter case there was some justification for departure from the general rule for the policy insured whiskey which had been aging for various periods of time. This aging had enhanced the value of the product and replacement with a like kind and quality could not be accomplished at the insured's cost of distillation or manufacture.

[105] Niagara Fire Ins. Co. v. Heflin, 60 S. W. Rep. 393; 22 Ky. Law Rep. 1212, and numerous other cases.

[106] Standard Sewing Machine Co. v. Royal Insurance Co., 201 Pa. 645; 51 Atl. 354. But policies issued by various factory mutual fire insurance companies are adjusted upon the basis of the selling price rather than the cost of reproduction. (See annual reports of the companies).

in bond."[107] Where the policy so provides the manufacturer's profit is included in the coverage of the direct damage policy and there is no need for profit insurance. Where valued policies are written on goods there is likewise no need for profit insurance for the profit may be incorporated within the valuation agreed upon. In the large majority of cases, however, the one in possession of goods which he is holding for sale or for delivery can recover only their cost to him. Upon their destruction his opportunity to sell them and his expected profit or commission from their sale vanishes. The requirements in order that an insurable interest exist are satisfied. The right to insure against a loss of profits on goods has long been established,[108] and frequently upheld.[109]

There is an inevitable conflict between the insurable interests supporting profit and use and occupancy insurance policies. While there is no question as to the existence of an insurable interest in profits on goods where a merchant possesses a stock of goods for sale, his loss of profits or commissions is better covered under a use and occupancy policy. The loss to him is a loss which may be measured by the sales which are prevented upon the destruction of the property and not by the amount of goods which he had on hand. A merchant with a stock of goods which he turns over once every four months would be able to realize immediately from a profit insurance policy the total profit which would have required four months to be realized in the regular course of his business. Within a month after the loss it is possible that he could have replaced his entire stock and resumed business. By the end of four months he would have realized three months' profits from his operations, and four months' profits from his profit insurance policy. Had he also had use and occupancy insurance he would have obtained his lost profits for the month during which the business was interrupted. Such a situation would be productive of a considerable moral hazard, so merchants usually are refused profits insurance in favor of use and occupancy insurance.

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[107] See Rule 69, p. 55. Eastern Underwriters Association Rules.
[108] 1781—Grant v. Parkinson, 3 Doug. 16.
[109] See *Joyce on Insurance*, Vol. II, pp. 2100–2102.

The situation of a manufacturer of goods is different. If only his warehouse and finished goods are destroyed the use and occupancy insurance policy provides no indemnity. His business of producing goods has not been interrupted and the policies issued to manufacturing risks specifically provide that there shall be no liability "for loss resulting from damage to or destruction of finished stock or for the time required to reproduce any finished stock which may be damaged or destroyed." To replace such goods without loss, since he obtains no indemnity for the loss of time necessary to reproduce them, it is necessary that he be put in a position to buy them in the open market. Their price will be the price at which he could have sold his goods had they not been destroyed. He would lose, then, the difference between this market price and the cost of reproduction since the latter is the limit of his recovery under his direct damage insurance policy.[110] Both profit insurance and use and occupancy insurance, therefore, may be written on a manufacturing risk.

Insurable Value—Profits and Commissions Insurance.

The extent of the loss of profits or commissions which may be suffered upon the destruction of the goods is measured by the difference between the price at which the goods could have been sold in the ordinary course of the insured's business and the cost of such goods to the insured, including the expense incurred in placing them on the market. This is equally true whether the interest be a profit or a commission interest. The amount of the profit or commission interest will vary as the amount of goods at risk varies. It will also depend upon the relative changes

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[110] Since a merchant recovers under his direct damage insurance the amount which it would cost him immediately to purchase the quantity of goods destroyed, and since such replacement may be effected immediately, it is possible that the merchant would suffer no loss of time to correspond to the loss of time necessary for a manufacturer to reproduce the goods destroyed. In other words, the merchant can use the proceeds from his insurance on the goods to go into the market and buy goods without any loss, but were the manufacturer to go into the market and buy the quantity of goods destroyed he would suffer a loss (amounting to his profits), for his insurance covered only the cost of reproduction, which takes time. Usually, too, it is impossible for the manufacturer to buy the same quality or kind of goods as those which he manufactures.

of the price at which they may be sold and of their cost. During the course of the policy's term adjustments of the amount of insurance should be made for the policies usually contain coinsurance clauses. If an insured sells his goods at 25 per cent over cost of production, paying 5 per cent commission to his salesmen, his profit is limited to 20 per cent of the cost of the goods. When he has on hand goods, the cost of which was $100,000, the extent of his insurable value in profits is $20,000. To recover in full for losses this amount of insurance is required. Usually the policies contain a coinsurance clause in which case at least the stipulated percentage of $20,000 must be carried in order that his losses of less than the amount of insurance required be paid in full. If the goods are held for sale on commission, the commission being 10 per cent of the selling price, the amount of the commission so determined is the insurable value. Where goods have been sold but not delivered the insurable value is the difference between the contracted selling price and the cost of the goods to the insured without regard to selling expenses, for the insured already has incurred these expenses and is legally responsible therefor.

Even though the policy may not specify whether it is the net or the gross profit on the goods which is to be covered this is of no concern to the insured, for if he carries insurance to the extent of 100 per cent of his *net* profits his actual losses will be paid at least in full, regardless of the coinsurance provision of the policy. To illustrate: An insured has $10,000 profits insurance in a policy containing a 100 per cent coinsurance clause. He has $100,000 worth of goods on which the gross profit will be $15,000 and the net profit $10,000. One-half of his goods are destroyed. His loss of net profits is, therefore, $5,000. It is decided that the policy covers gross profits rather than net profits. He should have been carrying $15,000 of insurance. But if he is required to carry insurance on *gross* profits his claim may also be based upon *gross* profits. His gross profit would have been $7,500. He receives that proportion of his claim of $7,500 which the insurance carried ($10,000) bears to the amount required ($15,000), *i.e.*, 10/15ths of $7,500, or $5,000, his actual loss. If the policy had contained an 80 per cent coinsurance clause and the

insured were carrying full insurance on his net profits of $10,000 all of his losses would be paid in full. If it were decided that the policy covered gross profits the insured could claim a loss of $7,500 which would be paid in the proportion which $10,000 bears to 80 per cent of $15,000 or 10/12ths. His recovery, of $6,250 then, represents more than his actual *net* loss. Consequently it will never be contended by an insurer that the amount of insurance required is to be based upon the gross profit of the insured, and the latter is safe in carrying only full insurance of his net profits.

III

Rent and Leasehold Insurance

It has been well established by court interpretation that liability for loss resulting from interruption of business, which includes the loss of rents or rental value of a property, is not assumed under the insurance covering the property itself.[1] The present policies also exclude such losses by specific provision that there shall be no "compensation for loss resulting from interruption of business or manufacture."[2] To cover such losses specific insurance is required. This insurance is effected by the use of a form attached to a direct damage insurance policy.

Rent Insurance—Hazards Covered.

Rent insurance may be obtained against the hazards of fire, sprinkler leakage, water damage, tornado and windstorm, earthquake, riot and civil commotion and simple explosion. In February 1929 provision was made for this form of insurance to be written (on residence risks only) against the hazard of boiler explosions.[3] Since the forms used in these lines are usually identical with, or substantially the same as, those used in conjunction with fire insurance policies, and, since the principles relating to the insurance of rents are the same for all the different hazards, the discussion from this point will refer principally to the insurance of rents against loss by fire.

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[1] See cases cited in Chapter 1.—Where the direct damage insurer has been held liable for the loss of rental value of the property insured, such liability has been established in an action for damages arising as a result of the negligence or fault of the insurer, and not in an action brought upon the insurance policy itself. Thus where the company elects to rebuild or repair property and fails to, or delays doing so, the insured can recover damages including loss of rents during the period of delay. See Phila. Fire Association v. Rosenthal, 108 Pa. St. 474, 1 Atl. 303; and Henderson v. Sun Mutual Ins. Co., 48 La. Ann. 1031, 20 So. 164.

[2] New York Standard Fire Insurance policy. Insuring clause.

[3] Circular No. 203, National Bureau of Casualty and Surety Underwriters. Dated 2-1-29. Effective 2-20-29. Insurance against loss of rents on other than residences is assumed in use and occupancy insurance forms.

Rent insurance may be written in conjunction with, or separately from, the fire insurance upon the building. In the first case the rent form is filled out and attached to the fire insurance policy on the property. Both risks are assumed in the same contract. Usually, however, the form is attached to an otherwise blank fire insurance policy form and the direct damage insurance is written separately. In either case the effect is to incorporate into the rent insurance coverage all those provisions of the direct damage insurance policy which are not inconsistent with it.

Fundamental Considerations Underlying Rent Insurance.

1. *The Time Element.*

Insurance against direct loss and damage provides for the payment of the value lost at the time the hazard insured against occurs. In rent insurance, as in other forms of business interruption insurance, the value is not lost at the time of the fire or other disaster, but the loss continues over a period of time. This time element is the greatest complicating factor of all such forms of insurance.

(a) The Period of Indemnity.

When a property is rendered untenantable the loss of rents or rental value continues from the time of the disaster until the property can be rendered fit for occupancy again, a more or less indefinite interval when the attempt is made to estimate it in advance. This is known as the period of indemnity in the policy, and there must appear a provision limiting the insurer's liability to the loss over such a length of time.[4] It is equally as important that this period of indemnity must not be limited by the date of expiration of the policy. If a fire occurs, for example, two days before the expiration of the policy term the insured's loss is definitely incurred at that time, though the

[4] An exception may be made of seasonal risks. In case the property is untenantable during the early part of the season it may be impossible to find a tenant for only the remainder of the season.

greater proportion of the benefits from the damaged property would not have been realized until after the policy had terminated. It is only necessary that the fire occur within the policy term in order that the insurer be held liable for the loss over the agreed upon period of untenantability.

(b) Fluctuations in Value.

Since the loss extends over a period of time, the value of the loss per unit of time must be ascertainable under the conditions of the policy. Because the loss under a direct damage policy is established by the value of the property at a particular time, viz., the time of the fire, this value is not subject to fluctuation. But since the rental value which is lost extends over a period of time in the future, it may fluctuate during that period.[5] This is particularly apparent in the case of seasonal risks such as summer resort property, where the rental value may be zero during the winter months of the year. Whatever fluctuation there may be in the rental value of the property must be provided for in the loss settlement provisions of the policy.

2. *Coinsurance.*

The principle of coinsurance is equally as important in rent insurance as in direct damage fire insurance. This principle is given effect by the requirement of an adequate ratio of insurance to value. The element of time again adds complications. Shall the value of the rents upon which the amount of insurance is to be based, be taken for some arbitrary period, or is a better standard of value available? In fire insurance the value to which the percentage of coinsurance is applied is the full value of the property, which, too, is the maximum value which possibly could be lost. The maximum value of the rent which could be lost is its value over the longest period which would be required

[5] The items included within the use and occupancy value of a business are even more subject to fluctuation. Consequently this point is of still greater importance in its application to the insurance of such use and occupancy value.

to restore the premises to a tenantable condition. Upon this amount, then, the insurance required for ordinary risks should be based.

3. Types of Losses.

The application of the principle of coinsurance to rent insurance is further complicated by the different types of losses which may occur. In fire insurance a loss is clearly either total or partial. But in rent insurance the distinction between total and partial losses is not so clear. A total loss is a maximum loss, and the maximum loss of rents which can be sustained would be that resulting from the complete untenantability of the property for the entire period required for its rebuilding. There is, then, a total suspension of rent for the whole period over which rent possibly could be lost as a result of the destruction of the property. Under a fire insurance policy a total loss would result in the payment of the whole amount of the insurance although the amount of insurance carried were less than that required by the coinsurance provision of the policy. But in the case of a total loss of rents, such as that described, the whole amount of the rent insurance carried would not be paid to the insured even though it is less than the amount of insurance required, for the reason that some coinsurance provisions require more insurance than the maximum loss which could be sustained.

There is frequently a loss which results from the complete untenantability of the property for a period of time less than that which would be required for the rebuilding of the property were it completely destroyed. While there is a total loss of the rent it can not be considered as a total loss for insurance purposes since it continues for only a limited time and does not represent a maximum loss. If the coinsurance provision is to be effective it must apply to losses of this type just as it does to partial losses under the fire insurance policy. The insured, if he does not carry the required amount of insurance, must be made to bear a proportionate part of any loss which is less in amount than the sum to which the property or rent should have been insured.

There is a third type of loss which is clearly a partial loss. Where only a portion of the property is rendered untenantable there is only a partial loss of the rent from the property regardless of the duration of the untenantability. Since the property is rendered only partially untenantable it will not require as long a period to repair the damage as would be required to completely rebuild it. Consequently such losses always will be partial in their duration as well as in their amount. The necessity for the application of the coinsurance provision to this type of loss is unquestioned.

Rent insurance losses then may be classified as: (1) Total losses, which are total both as to amount of rent and as to duration; and (2) partial losses, which are (a) total as to the amount of rent, but partial as to duration, or (b) partial as to the amount of rent, and partial as to duration.

4. *Other Considerations.*

The specific property, the untenantability of which causes the loss of rents which the policy is to cover, should be described carefully and adequately in the form. The subject matter of the insurance also should be clearly specified. It has been indicated that the policy may cover a loss of rents from the entire premises or from only those portions of the premises which are occupied or rented.[6] It has also been shown that there is a distinction between gross rents and net rents, and that, in the absence of any qualification, the coverage under the policy has been construed in both ways by different courts.[7]

The Development of Rent Insurance Forms.

1. *The First Recorded Form Used in the United States.*

While rent insurance was written prior to 1856[8] there is no

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[6] See Chapter 2, p. 37. While the use of the term, occupied, would imply that the interest of the owner occupant or lessee occupant of a portion of the premises was included in the coverage, modern forms provide specifically that such an interest is included.

[7] See Chapter 2, p. 36.

[8] See Chapter 1, pp. 17 and 19.

record of the forms used before that time.[9] In that year there appeared a form proposed for use, and later actually used[10] by an English insurance company in the United States.[11] This form recognized the principles that a rent insurance loss continues only for the length of time required for rebuilding or repairing of the property,[12] and that it is not limited by the expiration of the policy. It was also necessary that the fire damage the described property, a feature which has become less definite in the forms now in use.[13] But further than this it did not go. Had the form reached the courts it would probably have been construed to cover the gross rents of the entire building, whether or not such was the intention. No provision was made for the application of coinsurance, nor was a measure of the loss of rents stipulated, except insofar as the condition that "the sum insured will be taken as the yearly rent of the premises" could be so construed. While the intention of this provision probably was to require insurance to the full amount of the annual rent it is possible that it would have been construed as making the insurance valued. The dissimilarity of rent insurance and direct damage fire insurance again arises. In a rent insurance policy a valuation can only be established per unit of time, whereas in a valued policy in fire insurance the whole subject matter of the insurance is valued. The effect

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[9] Nor had any of the forms used been involved in court disputes, from the records of which early forms might have been obtained.

[10] That this form was used is evidenced by its appearance in C. C. Hine's *Book of Forms*, 3d Ed., 1882. Form No. 194, p. 84.

[11] *U. S. Insurance Gazette*, Vol. 2, No. 12, April, 1856, pp. 380–382. See Chapter 1, p. 19. The form provided as follows: "It is understood and agreed that it is the intent of the Company to fully indemnify the insured for any loss of rent he may sustain by a fire happening to the building, not exceeding the amount insured by this policy. Loss to be computed from the day of occurrence of any fire. Loss not to be limited by the day of expiration named in the policy. In case of total or partial loss of the building, it shall be assumed to be the duty of the insured, as a basis for the settlement of the loss of rent, to rebuild or repair, as the case may be, the premises, with all convenient dispatch and the sum insured will be taken as the yearly rent of the premises."

[12] By requiring rebuilding or repairs, "as a basis for the settlement of the loss."—Later policies provided that if the insured did not choose to rebuild or repair the time which would have been required to do so would be used as the basis for the loss adjustment. See also C. C. Hine's *Book of Forms*, 1865. Form No. 38, p. 24.

[13] See pp. 78–79.

of the provision referred to might have been to establish the value of the rents at one-twelfth of the face of the policy per month.

2. *Valued Policies.*

In 1865 there appeared a policy which clearly was valued, the insurance company agreeing to "pay at the rate of $500 per month, for whatever time the said building shall continue untenantable by reason of such fire," but not exceeding in total the face of the policy. The company further agreed to pay the full amount of the policy, $5000, in case of a total loss of the building by fire.[14] Many rent insurance policies were issued which were either valued[15] or analogous to valued policies.[16] There has been a tendency in the earlier days of all business interruption insurance lines to cover the risk with a valued policy. This may be accounted for easily by the fact that the value of these intangible subjects of insurance is much more difficult to determine and much more likely to occasion disputes than is that of tangible property. With the development in underwriting knowledge and in experience gathered in the adjustment of losses, the valued policy gradually disappears.

3. *An Attempt to Introduce Coinsurance.*

By 1882 there had been added to the provisions of the early rent insurance form a clause, "that this Company shall be liable only for such proportion of any loss as the sum hereby insured bears to the annual rental of the building."[17] Obviously the intention of the clause was to embody the principle of coinsurance within the form but since the form also provided that "the sum insured will be taken as the yearly rent of the premises," the proportion which the sum insured would bear to the annual rental of the premises always would be 100 per cent, regard-

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[14] A. C. Ducat, *Practice of Fire Underwriting*, Chicago, 1865, p. 29.

[15] See Richards, *Treatise on Insurance Law* (3d Ed.) 1912, Banks Law Publishing Co., New York, p. 74, Para. 59.

[16] See Joyce, *A Treatise on the Law of Insurance of Every Kind*, 1917, Vol. 1, p. 443, Sect. 168a.

[17] C. C. Hine's *Book of Forms*, 3d Ed., 1882. Form No. 194, p. 84.

less of the amount of insurance or the *actual* annual rent. Beyond question, for insurance purposes, the yearly rent was valued at the sum insured, and the coinsurance clause was rendered ineffective.

4. *The Form Adopted by the New York Tariff Association, 1896.*

In 1896 the Tariff Association of New York, predecessor of the New York Fire Insurance Exchange, prescribed a form of rent clause, the use of which was required of all members.[18] This was the first attempt to secure territorial uniformity in rent insurance forms. The form adopted differed but little from those in use at that time, embodying features of the several forms which had originated in 1856 and 1865. However, it did modify the coinsurance provision so that insurance to the amount of the "*actual* annual rent" of the premises was required. Whether this change from the preceding policies was sufficient to render the clause effective has not been determined. Since the policy still contained the stipulation that "the sum insured will be taken as the yearly rent of the building" it is possible that this valuation would have been accepted by the courts as representing the "actual annual rent."[19] In this case the effect

[18] *Rule Book*, 1896, p. 20. Adopted in January, 1896.—"It is understood and agreed, that if said building or any part thereof, shall be rendered untenantable by fire so as to cause an actual loss of rents to the insured, this Company shall be liable for such loss of rents not exceeding the sum hereby insured. The assured agrees to rebuild or repair said building in as short a time as the nature of the case will admit, and the sum insured will be taken as the yearly rent of the building, and this company shall be liable only for such proportion of any loss as the sum hereby insured bears to the actual annual rent of said building. Loss to be computed from the date of the fire and to cease upon the building being again rendered tenantable. In case the assured shall elect not to rebuild or repair, then the loss of rent shall be determined by the time which would have been required for such purpose." The remainder of the clause provided in detail for the appraisal of the time required for rebuilding or repairs if such time were disputed. Such a provision was superfluous and later was abandoned. See p. 82.

[19] In 1911 the Kansas Supreme Court held that the provisions of a valued policy law, making the amount named in the policy conclusive evidence of value in case of total loss, do not apply to a rent insurance policy. Amusement Syndicate et al v. Prussian National Insurance Co. et al—116 Pac. Rep. 620. The reason for this is that, while the annual rent may be insured, a lesser period of time than one year may be required to render the premises tenantable. In other words total destruction of the property does not result in a total loss of the whole amount of the insurance, though there is a total loss of the rent.

would have been the same as that of the clause previously referred to.

This clause was used until 1904 when new forms were devised[20] to overcome some of the objections to it. These forms prevailed throughout the east until 1918 and still are used in the territory under the supervision of the New York Fire Insurance Exchange.[21] In 1918 a new series of forms, closely modeled after some which had appeared in New Jersey in 1915,[22] was promulgated by the Uniform Rules and Clauses Committee of the Eastern Union,[23] and gradually adopted by the rating organizations having immediate jurisdiction in the Eastern territory. These forms, with but few modifications, are employed at the present time in the jurisdictions in which they were adopted.[24]

Lack of Uniformity in Rent Insurance.

There is no standard rent insurance form required or provided by law. This type of insurance is relatively free from specific legislative requirements or restrictions,[25] as are other business interruption lines. The general insurance laws, and those relating to insurance against the hazards assumed under the rent insurance forms, are applied also to rent insurance. It is because of these laws that there exists some of the lack of uniformity found in these fields. What uniformity there is has been brought about principally through the efforts of sectional fire underwriters' associations and rating bureaus. Within the territory over which each exercises advisory or supervisory influence uniformity has been secured, but for the country as a

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[20] *New York Fire Insurance Exchange Rule Book*, 1923, p. 70. One of the forms then adopted had been used in Philadelphia in 1902. See *Philadelphia Fire Underwriters' Association Rules*, Edition of 1908, p. 106.

[21] *New York Fire Insurance Exchange Rule Book*, 1923, p. 70.

[22] *Schedule Rating Office of New Jersey Rules*, 1915.

[23] *1919 Rule Book*. Eastern Union.

[24] See Rule Book of any such association or organization in the eastern section of the United States.

[25] In Minnesota there is a provision in the laws applying specifically to rent, leasehold and use and occupancy insurance, which requires the use of a prescribed clause defining the period of indemnity under the contract. Sect. 231, Par. 2. This is as far as any specific legislation has gone.

whole no such uniformity exists. In the territory embraced by the Eastern Underwriters' Association a distinct series of forms has been developed. A different set of forms is used in the central and western states under the jurisdiction of the Western Underwriters Association.[26] Still another plan of underwriting has been utilized in the far western states included within the territory of the Board of Fire Underwriters of the Pacific.[27] Thus, there are three distinct sets of rent insurance forms,[28] the fundamental difference between each being in the application of the coinsurance principle. Since the provisions of the various forms are substantially uniform in other respects, these uniform provisions will now be considered.

Description of the Rent Covered.

The forms usually specify that the coverage is on the "rents," "rental value" or "rental income" of the described property,[29] and then proceed to define the term used in such a way that the coverage will be restricted to the "net," rather than the "gross" rents. In the Eastern forms, for example, the policy specifies that it covers: "$ . . . on the rental value of the described building, . . . The term rental value, wherever used in this contract, shall mean the determined rental less such charges and expenses as do not necessarily continue." A similiar provision is not found in the forms provided by the New York Fire Insurance Exchange, nor in those of the Southeastern Under-

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[26] Including also the territory of the Mountain States Inspection Bureau.

[27] In the territory covered by the Southeastern Underwriters' Association provision is made for the writing of forms similar to those used in the Eastern and to those used in the Pacific territory.

[28] These will be referred to hereafter as the Eastern, the Midwestern and the Pacific forms, respectively. The Eastern forms are used in Me., N. H., Vt., Mass., R. I., Conn., N. Y., N. J., Penna., Md., Del., W. Va., and Ark. The Midwestern forms are used in Ohio, Ind., Ill., Ky., Tenn., Mich., Wis., Minn., N. Dak., S. Dak., Iowa, Neb., Kan., Mo., Okla., Wyo., Col., and N. Mex. The Pacific forms are used in Mont., Idaho, Wash., Ore., Cal., Nev., Utah, and Arizona. In the territory covered by the Southeastern Underwriters' Association, embracing Va., N. C., S. C., Ga., Fla., Ala., Miss., La., and Texas, provision is made for the writing of forms similar to those used in the Eastern territory and others similar to those used in the Pacific territory.

[29] The terms rent and rental value have been used as though they denoted separate types of insurance. Both interests are covered under the same forms, the terms being used to some extent interchangeably.

writers' Association. In these latter forms, the term, rents, being used without further qualification, it is uncertain as to whether "gross" or "net" rents are covered.

The interest of the insured occupant is included usually by specific provision that: "If the insured occupies any portion of said building, a fair rental value of the portion so occupied shall be considered as a part of the rental value insured."

Rent insurance forms may be classified as to whether the rental value, as defined, is to include that of (1) the entire premises, whether rented or vacant, or (2) only the portions of the premises which are occupied or rented at the time of the fire. In each jurisdiction provision is made for the issuance of policies on either basis, the insuring clause and the coinsurance clause being modified so as to extend or limit the coverage as desired.

The Premises Covered.

The necessity for a description of the premises, the untenantability of which gives rise to the loss of rent, is apparent. The rent insurance rate is based upon the fire insurance rate of the specified property, and this latter rate depends upon the nature and occupancy of the property. This leads to the conclusion, and it is unquestionably the intention, that the untenantability should result from direct damage to the described premises. But that this must be the case is not apparent in the forms in use. In the Eastern forms the insuring clause provides that, "if the said premises . . . shall be rendered untenantable by fire . . . occurring during the continuance of this policy, this Company shall thereupon become liable . . . " If a fire occurs in a heating plant separately maintained by the insured, but not described in the policy, the resulting untenantability of the described premises satisfies the conditions of the insuring clause. The insurance company probably would be held liable for the ensuing loss of rental value.[30] The indefiniteness of the form

[30] No such case has reached the courts, but the form, being capable of either interpretation, probably would be construed favorably to the insured. Since the rent endorsement is inconsistent with, and supersedes, the direct damage provision of the policy to which it is attached, recourse can not be had to this provision. Such a loss should be covered under a form of use and occupancy insurance.

could be remedied by its modification so that the clause would read, "If the said premises . . . shall be rendered untenantable by *direct damage by* fire . . . occurring *thereto* . . ." In other than the Eastern forms the argument is equally as strong and the defect may be as easily remedied.

The Period of Indemnity.

In the Midwestern forms the period of indemnity is limited in all forms by providing for the "loss to be computed from the date of the occurrence of said fire and to be determined by the time it would require, under ordinary circumstances, to put the premises in tenantable condition." No provision is made for the extension of the period of indemnity beyond the termination of the policy. Though such a stipulation appears in all except the Midwestern forms, it is unnecessary for it has been held that the policy covers the loss over such a period even though there is no specific provision to that effect.[31] The time required to render the premises again tenantable has been held to include the time necessary in placing the contract for repairs,[32] but not the delay occasioned by order of any civil authority or by ordinance or law regulating the construction or repair of buildings, the provisions of the fire policy to which the form is attached applying in this case.[33] If the insured is unable to, or elects not to, rebuild the destroyed property the period of indemnity is determined by the time which would have been required to reconstruct the building destroyed had it been permissible or

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[31] Becker v. Merchants' Mutual Insurance Co. (La.) 22 Ins. L. J. 227. (1893).

[32] Hartford Fire Ins. Co. v. Pires, 165 S. W. Rep. 565. As a matter of practice the insurance companies allow indemnity for the time required in making the adjustment of the loss under the direct damage insurance contract, for until such adjustment is made repairs will not ordinarily be started.

[33] Palatine Ins. Co. v. O'Brien, 68 Atl. Rep. 484; 71 Atl. Rep. 775; 107 Md. 341; 16 L. R. A. (N. S.) 1055.—After the Baltimore conflagration in 1904 an ordinance was passed re-locating street lines and the issuance of a building permit by the municipal authorities was delayed. It was held that the insurer under a rent insurance policy was not liable for the loss of rent during the delay.

had the insured so desired.[34] The effect of these decisions has been embodied in a special clause which appears in the Pacific forms, but not in those of other jurisdictions.

In the Eastern[35] and the Pacific forms the period of indemnity is differently defined, depending upon whether the rental value of the entire premises or that of only the occupied and rented portions of the premises is covered. When the rental value of the entire premises is the value insured, the period of indemnity is the same as that of the Midwestern forms, *i.e.*, the period necessary to restore the *entire* premises to a tenantable condition. But if the value insured is the rental value of only those portions of the premises which are occupied or rented at the time of the fire, the period of indemnity is only the period necessary to restore *such portions* of the premises to a tenantable condition. While in many cases this distinction will be of no value,[36] it will prevent an insured from making a profit from his insurance by repairing the formerly vacant portions of his property first, letting these portions out to his former tenants, and, in addition, collecting from the insurance company the rent of the formerly rented portions of the premises for the period until the entire property has been rendered tenantable again.

But such a stipulation does not cover a somewhat similar situation. Where the fire renders untenantable only an occupied portion of the premises and the tenant is able to move into an equally desirable portion which was undamaged and which was unoccupied or unrented at the time of the fire, it is evident that the insured has suffered no loss contemplated by the policy covering only the rents of the occupied or rented portions of the

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[34] Thus, where a city ordinance prohibited the rebuilding of a property as a theatre, and an office building was erected in its place, the loss was confined to the period which would have been required to construct a building the same as that destroyed, without allowance for the time required for submission of proof of loss, for removal of debris, or for delay incident to the inclement weather following the fire. Amusement Syndicate et al v. Milwaukee Mechanics' Insurance Co., 136 Pac. Rep. 941. Also Amusement Syndicate et al v. Prussian National Ins. Co. et al, 116 Pac. Rep. 620.

[35] Excluding the New York Fire Insurance Exchange and Southeastern Underwriters' Association forms.

[36] When it is necessary to rebuild the whole building, or when it is necessary to repair an unrented portion of the property before repairs on the rented portion can proceed.

premises. But there is no specific provision in any of the policies by which he is prevented definitely from recovering for the rent of the occupied portion of the property for the time required to render it again tenantable. This possibility could be avoided by inserting a clause in such forms which would provide somewhat as follows: It is a condition of this insurance that if, at the time of the fire, there are any portions of the described premises which are unoccupied or unrented, and which are still tenantable after the fire, said portions of the premises shall be used, if possible, in reducing the loss under this insurance.

In two forms which have been devised[37] for the coverage of seasonal risks, the period of indemnity is restricted to a designated period of the year, the company being "relieved from all liability for loss of rental value during the remainder of the year, *i.e.*, from . . . to . . . in each year, inclusive." In one form the period of indemnity is further limited to the period of time necessary to render the property tenantable; in the second no such restriction appears. If a property is used from May first to September thirtieth and a fire occurring on the first of February so damages it that four months will be required to put it into tenantable condition again, the insured's loss when covered under the first form is a loss of only one month's rent. The premises will be ready for occupancy by June first and the period from the fire to May first is excluded specifically. Under the second form, since there is no limitation of the period of indemnity to the period necessary to restore the tenantability of the property, the insured's loss covered by the policy may be considered a loss of five months' rent, the rent for the whole season.[38] The reason for such an extension of the coverage of the policy is that, in seasonal risks, if the property is untenantable at the beginning of the season, or is rendered untenantable during the season, it may be impossible to secure a new tenant or tenants for only the remainder of the season. The form provides, however, that if the premises are restored before the expiration

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[37] In the Eastern territory.

[38] Or the rent for the remainder of the season, when the fire occurs during the season.

of the rental season, "the company shall receive due credit for any recovery of rent thereby made obtainable, whether from the original lessee or other sources, in the adjustment of any claim under this policy." This provision prevents the insured from profiting under this form, restricting the indemnity to his actual loss after, as well as before, the usual period of indemnity would have expired.

The Appraisal Clause.

In every rent insurance form there is a clause which provides that, in case of disagreement, the time required to restore the premises to a tenantable condition shall be determined by appraisement in accordance with the conditions of the insurance policy to which it is attached. In some forms this clause also is made specifically applicable to disagreements as to the rental value of the portions of the property occupied by the insured. The inclusion of an appraisal clause in the rent insurance form itself is unnecessary, for the policy to which the form is attached provides for appraisal in any case where there is a disagreement as to the amount of the loss. Neither the length of the period of indemnity, nor the rental value of the property, can be in dispute, without the amount of the loss being in dispute. The appraisal clause of the policy itself, then, would apply to the conditions specifically designated in the appraisal clause of the rent insurance form. Since there is no conflict between this clause of the policy and any provision of the rent insurance form, it would apply even in the absence of any reference to appraisal in the latter.

Coinsurance Provision.

Rent insurance forms, excepting the Midwestern forms,[39] contain provisions by which the insurer becomes liable for only that proportion of any loss which the amount of insurance carried bears to the amount of insurance required. This latter

[39] The Midwestern forms are used in that section of the country in which anti-coinsurance legislation has been most prevalent.

amount may be based upon (1) the rental value of the premises[40] per annum, or (2) the rental value of the premises for the period of time which would be required to restore the premises to a tenantable condition if totally destroyed. In some cases in which the coinsurance requirement is based upon the annual rental value, insurance must be carried to its full amount. In other cases the clause may be modified so as to require insurance only to a stipulated percentage (50 per cent, . . . , or 100 per cent) of the annual rent. When it would require six months to rebuild a property it might be assumed that a clause which would require insurance of only 50 per cent of the annual rent would be the equivalent in cost and coverage of a clause requiring insurance of the amount of the rent for the period required for rebuilding. Such an assumption is incorrect for the reason that the latter clause will be written at a given rate whether the period required for rebuilding is six months or one year, whereas a clause requiring insurance of only 50 per cent of the annual rent will carry with it a rate considerably greater than that of one which requires insurance of 100 per cent of the annual rent.

When the amount of insurance required is the *rental value of the premises for the period of time which would be required to rebuild the property if totally destroyed*, losses being paid only in the proportion which the amount of insurance carried bears to that required, the provision would be truly a 100 per cent coinsurance clause were it possible to estimate accurately the time which would be required to rebuild. The amount of insurance required represents the maximum loss of rent which could be sustained, barring abnormal circumstances affecting the time necessary to make repairs or to rebuild. When losses are paid only in the proportion which the amount of insurance carried bears to the *full annual rental value of the premises*, the provision usually is referred to as a 100 per cent coinsurance provision. If the *maximum* time which may be required to rebuild or repair the property is six months, the amount of insurance actually required

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[40] Or the rental value of the occupied or rented portions only, if the coverage of the policy is so restricted.

is twice the maximum amount which can be lost,[41] 200 per cent of the amount at risk.[42] The attempt has been made to reconcile the policies issued upon these two bases by a difference in the rates applicable to each form, but such an adjustment as is made does not render them equivalent in cost though they may be equivalent in coverage. The coinsurance provisions which are based upon the annual rental value of the premises, without allowances in rate for differences in the length of the period required for rebuilding, allow relative inequalities in cost or coverage to arise on different risks. The question, however, cannot be divorced from a consideration of the rates charged for insurance on different risks and must be considered under that head.[43]

The Midwestern forms either are entirely free from any coinsurance provision, or they merely incorporate a provision by which the whole amount of insurance is distributed and the insurer's liability is limited to a certain maximum amount per month, usually 1/6, 1/9, or 1/12 of the face of the policy. The purpose of restricting the insurer's liability per month to 1/12 of the amount of insurance is to require insurance to the extent of 100 per cent of the annual rent, but that such a provision is not a coinsurance clause is evident. In any case where the loss of rent is less in amount per month than 1/12 of the face of the policy the full amount of the loss will be paid. Thus if a property produces a monthly rent of $1,000 and is so damaged that there is a loss of $100 per month, the insured will be fully indemnified so long as he is carrying rent insurance for an amount equal to, or larger than, 10 per cent of the annual rent. The only effect upon the policy of such a limitation is to break it up into a series

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[41] It is possible that within the term of the policy there might be more than one fire causing a greater loss than the rental value for a six month period. But, as in the direct damage policy, the amount of the loss paid reduces the amount of insurance and the policy must be reinstated. (See Van Nest et al v. Citizens Insurance Co. [Minnesota, S. C.] 158 N. W. Rep. 725.)

[42] If two years would be required to replace the property the clause would require insurance of only 50 per cent of the amount at risk.

[43] See pp. 106–107.

of twelve policies,[44] each one of which is completely free from any coinsurance feature. Consequently there is no violation of any anti-coinsurance law when forms of this type are used in the underwriting of rent insurance risks.[45] It is for this reason that they are used in the Midwestern territory where anti-coinsurance laws are most prevalent.

Types of Rent Insurance Forms.

1. *The Eastern Forms.*

In the Eastern territory rent insurance clauses of six different types may be obtained, four of which are for ordinary risks, and two for seasonal risks. The forms for ordinary risks may be classified according to the extent of the coverage under the form and according to the nature of the coinsurance provision. Coverage may be obtained upon the rental value of only those portions of the premises which are occupied or rented at the time of the fire, or upon the rental value of the entire premises whether rented or vacant at the time of the fire. To each of these types of coverage either of two plans of coinsurance may be applied.[46] That is, insurance may be required to the extent of the rental value for the time which would be necessary to rebuild, or to the extent of the full annual rental value.[47]

Coverage under the seasonal forms is based solely upon the rental value of the entire premises even though vacant at the time of the fire, for it is anticipated that, because of the nature of the property, it will be vacant for portions of the year and that a fire occurring then could produce a loss of rent. The co-

[44] This clause may be compared to a pro rata distribution clause used in direct damage insurance contracts. Here each month's rent is considered as a separate subject of insurance.

[45] In Heim v. American Alliance Ins. Co., 180 N. W. Rep. 225, decided in January, 1921, it was held that an insurance company could not lawfully use an endorsement upon the standard policy prescribed by law which would limit the insured's recovery to less than the amount of the actual loss and less than the amount of insurance. This is commonly referred to as the Minnesota rent case. It also had an effect upon the underwriting of use and occupancy risks, as will be seen later. Note 26, p. 151. See also *Minnesota Ins. Law*, Sec. 231, Para. 6, and Sec. 234.

[46] The coinsurance provision being modified so that it will be consistent with the coverage of the particular form.

[47] The forms prescribed by the N. Y. Fire Ins. Exchange are limited to those containing a coinsurance provision of the latter type.

insurance provision of both forms requires insurance to the full amount of the rental value of the premises for the season, the definite period of which is specified in the form. This provision corresponds to the provision in the forms for ordinary risks which requires insurance to the full annual rental value of the premises. The distinction between the two seasonal forms is to be found neither in the coverage nor in the coinsurance provisions of the forms, but in the determination of the period of indemnity over which the liability of the insurer shall extend in the case of a loss. This distinction has been explained before.[48]

The Eastern forms, then, may be summarized as follows:[49]

I. Forms for Ordinary Risks

Coverage	Coinsurance
(A) Whether rented or vacant	Based on time to rebuild
(B) Occupied or rented portions only	Based on time to rebuild
(C) Whether rented or vacant	Full annual rental value
(D) Occupied or rented portions only	Full annual rental value

II. Forms for Seasonal Risks

(A) Loss limited to period required for repairs (Form E).

(B) Loss not limited to period required for repairs (Form F).

2. *The Pacific Forms.*

In the Pacific territory instead of allowing selection between a coinsurance clause based upon the full annual rental value and one based upon the rental value for the time required to rebuild, all coinsurance provisions are based upon the annual rental value of the premises. Choice is allowed between different coinsurance clauses on this basis, some requiring less

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[48] See pp. 81 and 82.

[49] In New Jersey provision is made for two additional forms. The forms which have been described are used there to cover only the interest of an owner or lessor, specific forms being promulgated to cover a lessee's interest in rents paid in advance or for which he may become liable. One form is for use on ordinary risks, the other for use on seasonal risks. Both require insurance to the extent of the full annual rental value of the leased premises. The necessity for these additional forms is not apparent. A lessee's interest can be covered equally as well in the "occupied or rented" form for ordinary risks, or for seasonal risks in the form which limits recovery to the time required to render the premises again tenantable.

insurance than 100 per-cent of the annual rental value. Forms are obtainable under which insurance may be granted against loss of the rental value of only the occupied or rented portions of the premises, or against loss of the rental value of vacant or unoccupied buildings. When rent insurance coverage of the first type is written a basic form is used which contains a reduced rate average (coinsurance) clause. This clause may be varied so as to require insurance of any amount from 50 per cent up to 100 per cent of the annual rental value of the occupied or rented portions of the property. These clauses are referred to as 50 per cent, 60 per cent, . . . or 100 per cent reduced rate average clauses.[50] The second type of coverage, being considered extremely hazardous, is discouraged by always requiring that insurance to the extent of 100 per cent of the annual rental value be carried, and by charging a rate two and one-half times as large as that charged for a comparable policy on the rental value of the occupied or rented portions of the property alone. A special form is made available for the coverage of dwelling house rents or rental values. This form also requires insurance to the full value of the annual rent, but its use is encouraged by allowing a substantial (50 per cent) reduction in rate. No provision is made for the writing of seasonal risks upon a separate form.[51]

3. *The Southeastern Forms.*

In the territory over which the Southeastern Underwriters Association has jurisdiction rent insurance forms have been adopted which embody features of both the Eastern and the Pacific forms. Coverage may be obtained upon the rental value of the occupied or rented portions of the premises, or upon the rental value of the whole premises whether rented or vacant. Upon either of these bases forms corresponding to the Eastern forms may be written requiring insurance to the amount of the full annual rent, or to the amount of the rent for the period

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[50] But, see discussion of coinsurance provisions, pp. 82–85.
[51] Seasonal risks are written under ordinary forms.

which would be required to rebuild the premises. In addition, however, there are also forms, corresponding to the Pacific forms, requiring insurance to only 75 per cent of the annual rent (*i.e.*, based upon nine months' rent), or to only 50 per cent of the annual rent (*i.e.*, based upon six months rent). There is also a special form for seasonal risks which, in all except minor respects, is the same as the Eastern form in which the loss is limited to the period of time required for the actual repairing of the damage. For especially good risks an additional form is provided which covers loss of rents from the *whole* premises *whether rented or vacant*, but which requires the insured to carry insurance only to the extent of 50 per cent of *the actual rentals of the occupied or rented portions of the premises.* This form is subject to criticism not only because of its fundamental error in underwriting principle, but also because of its ambiguous construction. It is the intention of the form to require an amount of insurance equal to 50 per cent of the actual *annual* rentals of the occupied or rented portions of the premises, but no such unit of time is mentioned or even suggested in the form itself. The more fundamental error is in basing the *insurance requirement* upon the rental of the *occupied or rented portions* of the premises, and at the same time providing for the *payment of loss* of rental from the *whole* premises whether rented or vacant. Such a plan would find a duplicate in direct damage fire insurance were it possible to issue a policy which would pay in full any loss on a building *and its contents* provided only that insurance were carried to the extent of 50 per cent of the value of the building alone. The defect of such a scheme is obvious.

4. *The Midwestern Forms.*

As has been stated before, the Midwestern rent insurance forms contain no coinsurance provision.[52] Forms are provided in which there is no restriction whatever upon the amount of the insurer's liability in case of a partial loss, all losses up to the face amount of the policy being paid in full. Under these forms the

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[52] See p. 84.

coverage of the policy is extended to include the rental value of vacant or unrented portions of the premises as well as those which are occupied.[53] Other forms are provided in which the insurer's liability is limited to a stated portion of the sum insured for each month during which the premises remain untenantable. This portion may be 1/6, 1/7, 1/8, . . . or 1/12 of the amount of insurance, the clause being left blank so that any of the preceding fractions may be inserted.[54] When forms of this type are used coverage may be granted to cover the rental value of the occupied or rented portions of the property alone,[55] or the rental value of the entire premises.[56] Special forms are provided for use on dwelling risks, but these differ in no essential respects from those which are provided for other risks. No special forms are promulgated for seasonal properties.[57]

Rent Insurance Loss Adjustments—Procedure.

Rent insurance loss adjustments have occasioned relatively little difficulty for the insurance companies. Few cases involving rent insurance losses have reached the courts, most settlements being effected directly by the insurance adjusters. Since the rent insurance form is attached to a standard fire insurance policy form the obligations imposed upon the insured under the latter form as regards notice of the loss, proof of loss and appraisal are binding, so far as they are consistent, in the case of a rent insurance loss. All of these requirements must be considered in the light of the rent insurance form. The provisions of the fire policy having been designed to cover direct damage risks requires separation of the damaged from the undamaged property, a complete inventory of the destroyed, damaged, and undamaged property, stating the quantity and cost of each article, and similar

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[53] Midwestern Form No. 4. This form has been discontinued recently. (1930).

[54] If a building is not fireproof the monthly limit of the insurer's liability may be either one-ninth or one-twelfth; if fireproof, any limit from one-sixth to one-twelfth is permitted.

[55] Midwestern Form No. 1.

[56] Midwestern Form No. 2.

[57] Seasonal risks can be covered equally well under an ordinary form "without a limit of loss per month."

conditions which are inapplicable when the interest covered is an interest in rent.

The first step taken in a rent insurance loss adjustment is to establish the fact of a loss. This requires proof of the existence of an insurable interest in the rent insured. Such an interest may be proven by the submission in evidence of the deed or the lease under which the property is occupied. When the interest has been established satisfactorily the fact that an actual loss has been suffered must be determined. The mere fact that a fire has occurred and that the premises have been rendered untenantable is not sufficient. If the insured has received rent from a tenant during the period of repairs he has suffered no actual loss of rent as a result of the untenantability of the property.

The next step is to determine whether the loss is of a nature such that it falls within the terms of the rent insurance forms. These forms are written so as to cover only actual losses of rent or rental value and not to cover other losses resulting from the untenantability of the property. Thus, where an insured had been able through extraordinary diligence in the repair of the property to render it tenantable again before the expiration of a month, and the tenant had paid the rent while repairs were being made, the insured was held to have incurred no loss contemplated by the policy.[58] While the insured had suffered a loss because of the extra expense to which he had gone in securing the rapid repair of the property, it was not a loss of rent. The insurer actually benefits by such expenditures through a reduction of the amount of the loss covered by the policy, and consequently should assume responsibility and indemnify the insured for these extra expenses so long as they do not exceed the amount of the loss avoided.

Having found that there is an actual loss of rent or rental value it is necessary to determine the amount of it which falls within the scope of the coverage of the particular type of rent insurance form written on the risk. To find the amount of

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[58] Hartford Fire Insurance Company v. Northern Trust Co., 127 Ill. App. 355.

the loss two factors must be established:—the value of the rent[59] for the portions of the property covered by the policy[60] which have been rendered untenantable, and the period which will be required to restore them to tenantability. The value of the rent may be established by examination of the leases under which the property was occupied or the accounts of the landlord and tenant. If the insured occupied all or part of the premises himself, or if the policy covered vacant portions of the property, it may be determined by ascertaining for what amount premises similar in all respects could have been obtained at the time of the loss. This may be established by the estimates of competent real estate agents. The time which will be required to restore the damaged portions of the property contemplated by the policy to a condition of tenantability ordinarily will be established by the estimate of a reputable builder. In some cases the insurer may allow repairs to be made and then settle the loss on the basis of the time actually taken.

The only remaining question is, for what amount of the established loss is the insurance company responsible? When the rent or rental value of the damaged portions of the property was estimated, an estimate was also made of the rental value of all of the property included within the form. This value, extended for a year, is the insurable value under forms written on an annual basis. If the form is one requiring insurance to the extent of the rental value for the time which would have been required to rebuild had the property been totally destroyed, the determined rental value will be extended for such a period of time, which will be ascertained by the estimate of a builder. Having determined the required amount of insurance, the insurer's liability is fixed by the proportion existing between the insurance carried and that required.

Rent Insurance Loss Adjustments—Illustrated.

The application of the various policy forms, and the settlement of rent losses under these forms, may be illustrated by the following cases:

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[59] Usually the "net" value. See pp. 77–78.

[60] That is, the occupied portions only, or the entire premises.

1. *Ordinary Risks.*

A property has a net monthly rental value of $1000 when a fire occurs. This value comprises a net income of $600 per month from leased portions of the property, a rental value of $200 per month for that portion of the property occupied by the insured himself, and a rental value of $200 per month for the portions of the property which were vacant. If the property were totally destroyed eight months would be required to rebuild it.

Case I.—The property is totally destroyed by fire. The loss sustained on the occupied portion of the property is $6400 (8 months at $800 per month), and on the vacant portion of the property is $1600 (8 months at $200 per month).

Case II.—The property is so damaged that it is rendered wholly untenantable for a period of three months required for repairs.

The loss sustained on the occupied portion of the property is $2400 (3 months at $800 per month), and on the vacant portion of the property is $600 (3 months at $200 per month).

Case III.—The property is so damaged that

(a) Two-thirds of the rented portion is rendered untenantable for a period of five months. Loss sustained $2000 (5 months at $400 per month).

(b) The vacant portion of the property is rendered untenantable for a period of five months. Loss sustained $1000 (5 months at $200 per month).

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	
				(a)	(b)
EASTERN FORM "A" "*Whether Rented or Vacant—Based on Time to Rebuild.*—It is hereby provided that if said premises or any part thereof, whether rented at the time or not, shall be rendered untenantable by fire or lightning occurring during the continuance of this policy, this Company shall thereupon become liable for the rental value of such untenantable portions. Loss to be computed from the date of fire or damage by lightning, until such time as the building could, with reasonable diligence and dispatch, be rendered again tenantable, although the period may extend beyond the termination of this policy. In consideration of the reduced rate at which this policy is written, it is agreed that this Company shall not be liable, under this policy, for a greater proportion of any loss that may occur than the sum hereby insured bears to the rental value of the whole of said premises for the time that would, with reasonable diligence and dispatch, be required to rebuild and restore the same to a tenantable condition, if totally destroyed." The amount of insurance required is 8 months' rental value ($1,000 per mo.)—$8,000.	$8,000 (100%) $4,000 (50%)	$8,000 (100%) $4,000 (50%)	$3,000 (100%) $1,500 (50%)	$2,000 (100%) $1,000 (50%)	$1,000 (100%) $500 (50%)
EASTERN FORM "B" "*Occupied or Rented Portions Only—Based on Time to Rebuild.*—It is hereby provided that if said premises or any part thereof, occupied or rented at the time, shall be rendered untenantable by fire or lightning occurring during the continuance of this policy, this Company shall thereupon become liable for the rental value of such untenantable portions. Loss to be computed from the date of fire or damage by lightning, until such time as the occupied or rented por-					

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	
				(a)	(b)
tions of the building could, with reasonable diligence and dispatch, be rendered again tenantable, although the period may extend beyond the termination of this policy. In consideration of the reduced rate at which this policy is written, it is agreed that this Company shall not be liable, under this policy, for a greater proportion of any loss that may occur than the sum hereby insured bears to the rental value of the whole of the occupied or rented portions of said premises for the time that would, with reasonable diligence and dispatch, be required to rebuild and restore the same to a tenantable condition, if totally destroyed." The amount of insurance required is 8 months' rental value of the occupied or rented portions only ($800 per month)—$6,400.	$6,400 (100%) $4,000 (62.5%)	$6,400 (100%) $4,000 (62.5%)	$2,400 (100%) $1,500 (62.5%)	$2,000 (100%) $1,250 (62.5%)	— —
EASTERN FORM "C" "*Whether Rented or Vacant—Based on Annual Rental Value.*—It is hereby provided that if said premises or any part thereof, whether rented at the time or not, shall be rendered untenantable by fire or lightning occurring during the continuance of this policy, this Company shall thereupon become liable for the rental value of such untenantable portions. Loss to be computed from the date of fire or damage by lightning, until such time as the building could, with reasonable diligence and dispatch, be rendered again tenantable, although the period may extend beyond the termination of this policy. In consideration of the reduced rate at which this policy is written, it is agreed that this Company shall not be liable, under this policy, for a greater proportion of any loss that may occur than the sum hereby insured bears to the rental value of the whole of said premises per annum." The amount of insurance required is 12 months' rental value ($1,000 per mo.)—$12,000.	$12,000 (100%) $4,000 (33⅓%)	$8,000 (100%) $2,667 (33⅓%)	$3,000 (100%) $1,000 (33⅓%)	$2,000 (100%) $667 (33⅓%)	$1,000 (100%) $333 (33⅓%)

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	
				(a)	(b)
EASTERN FORM "D" "*On Occupied or Rented Portions Only—Based on Annual Rental Value.*—It is hereby provided that if said premises or any part thereof, occupied or rented at the time, shall be rendered untenantable by fire or lightning occurring during the continuance of this policy, this Company shall thereupon become liable for the rental value of such untenantable portions. Loss to be computed from the date of fire or damage by lightning, until such time as the occupied or rented portions of the building could, with reasonable diligence and dispatch be rendered again tenantable, although the period may extend beyond the termination of this policy. In consideration of the reduced rate at which this policy is written, it is agreed that this Company shall not be liable, under this policy, for a greater proportion of any loss that may occur than the sum hereby insured bears to the rental value of the whole of the occupied or rented portions of said premises per annum." The amount of insurance required is 12 months' rental value of the occupied or rented portions only ($800 per mo.)—$9,600.	$9,600 (100%) $4,000 (41⅔%)	$6,400 (100%) $2,667 (41⅔%)	$2,400 (100%) $1,000 (41⅔%)	$2,000 (100%) $833 (41⅔%)	— —
PACIFIC FORM 1. "*Occupied or Rented Portions Only.*—It is understood and agreed that this policy is intended to cover the actual loss of rental income from rented portions of the building above described, resulting from fire which renders such rented portions untenantable, and the rental income shall be estimated according to bona fide leases, contracts or agreements in force on the rented portions of the building at the time of fire, less such expense as the insured is relieved of, on account of said fire. If the insured occupies any portion of said building, a fair rental value of the portion so occupied shall be considered as a part of the rental income insured.					

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	
				(a)	(b)
The amount of loss (if any) shall be estimated and computed from the date of the occurrence of the fire to the end of the period that would be required, with due diligence, to restore with material of like kind and quality, the rented portions of the affected building, to the same tenantable condition as existed at the time of the fire. In consideration of the reduced rate at which, and the form under which this policy is written, it is expressly stipulated and made a condition of the contract that, in event of loss, this company shall be liable for no greater proportion thereof than the amount hereby insured bears to.....per cent (.....%) of the annual rental income from bona fide leases, contracts or agreements in force on the rented portions of the building at the time of fire, less all expenses which in event of total destruction of the building the insured would be relieved of." If 100% is inserted in the above clause the amount of insurance required is 12 months' rental value of the occupied or rented portions only. ($800 per mo.)—$9,600.	In this case the form operates exactly as in the case of the Eastern form "D"				
If 50% is inserted in the above clause the amount of insurance required is 50% of 12 months' rental value of the occupied or rented portions only.—$4,800.	$4,800 (100%) $4,000 (83⅓%)	$4,800 (75%) $4,000 (62.5%)	$2,400 (100%) $2,000 (83⅓%)	$2,000 (100%) $1,667 (83⅓%)	
PACIFIC FORM 2. *Rented or Vacant.*—When the coverage is extended to include the rental value of vacant portions of the property a form similar to that given above is used, but only 100% may be inserted in the coinsurance clause. The amount of insurance required is, then, 100% of the annual rental value of the entire premises, or $12,000.	In this case the form of Eastern Form "C" operates exactly as in the case				

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	
				(a)	(b)
SOUTHEASTERN FORMS.					
In addition to all of the preceding forms the Southeastern associations provide a form, similar to the last-mentioned Pacific form, in which 75% or 50% may be inserted in the coinsurance clause. If 50% is inserted in the clause the amount of insurance required is 50% of the annual rental value of the entire premises, or $6000.	$6,000 (100%)	$6,000 (75%)	$3,000 (100%)	$2,000 (100%)	$1,000 (100%)
	$4,000 (66⅔%)	$4,000 (50%)	$2,000 (66⅔%)	$1,333 (66⅔%)	$667 (66⅔%)
MIDWESTERN FORM 1.					
"*Occupied or Rented Portions Only* (with limit of loss per month).—The term 'rents' wherever used in this policy shall mean the determined rents of portions occupied by other than the insured and the term 'rental value' shall mean the determined rental value of such portions occupied by the insured for his own use; less such charges and expenses as do not necessarily continue after the fire.					
In case the above described building, or any part thereof, shall be rendered untenantable by fire, this Company shall be liable to the insured for not exceeding the actual loss sustained based upon loss of rents ensuing therefrom, not exceeding the sum insured, nor one .....of that amount for any one month, and proportionate part thereof for any period less than one month, loss to be computed from the date of the occurrence of said fire, and to be determined by the time it would require, under ordinary circumstances, to put the premises in tenantable condition."					
If the limit expressed in the form is one-twelfth, the insurance which should be carried is 12×$800, or $9,600.	$9,600 (100%)	$6,400 (100%)	$2,400 (100%)	$2,000 (100%)	—
	$4,000 (41⅔%)	$2,667 (41⅔%)	$1,000 (41⅔%)	$1,667 (83⅓%)	—
If the limit expressed in the form is one-eighth, the insurance which should be carried is 8×$800, or $6,400.	$6,400 (100%)	$6,400 (100%)	$2,400 (100%)	$2,000 (100%)	—
	$4,000 (62.5%)	$4,000 (62.5%)	$1,500 (62.5%)	$2,000 (100%)	—

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	
				(a)	(b)
MIDWESTERN FORM 2.					
Rented or Vacant (with limit of loss per month).—When the coverage is extended to include the rental value of vacant portions of the property a form similar to Midwestern Form No. 1 is used. When one-twelfth of the amount insured is stated as the limit of recovery per month, the amount of insurance which should be carried is 12× $1,000 or $12,000.	$12,000 (100%) $4,000 (33⅓%)	$8,000 (100%) $2,667 (33⅓%)	$3,000 (100%) $1,000 (33⅓%)	$2,000 (100%) $1,667 (83⅓%)	$1,000 (100%) $1,000 (100%)
When one-eighth of the amount of insurance is stated as the limit of recovery per month, the amount of insurance which should be carried is 8×$1,000, or $8,000.	$8,000 (100%) $4,000 (50%)	$8,000 (100%) $4,000 (50%)	$3,000 (100%) $1,500 (50%)	$2,000 (100%) $2,000 (100%)	$1,000 (100%) $1,000 (100%)
MIDWESTERN FORM 4.[61]					
"*Rented or Vacant* (without limit of loss per month).—In case the above described building, or any part thereof, whether rented at the time or not, shall be rendered untenantable by fire, this company shall be liable to the insured for not exceeding the actual loss sustained based upon loss of rents and/or rental value of such untenantable parts, not exceeding the sum insured; loss to be computed from the date of the occurrence of said fire, and to be determined by the time it would require, under ordinary circumstances, to put the premises in tenantable condition."	$8,000	$8,000 (100%)	$3,000 (100%)	$2,000 (100%)	$1,000 (100%)
Under this form no particular amount of insurance is required.	$4,000	$4,000 (50%)	$3,000 (100%)	$2,000 (100%)	$1,000 (100%)

[61] Midwestern forms Nos. 3 and 3a are omitted since they are Dwelling rent forms based upon the same principles as the other Midwestern forms.

2. *Seasonal Risks.*

A summer resort property has a rental value of $1,000 per month during the season which lasts from the first of May till the last of September, a period of five months. If the property were totally destroyed six months would be required to rebuild it.

Case I.—The property is totally destroyed by a fire occurring on the fifteenth of April. Since the property can not be rebuilt before the fifteenth of October the rental value of the property for the whole season is lost, viz. $5,000.

Case II. The property is totally destroyed by a fire occurring on the fifteenth of February.[62] It can be rebuilt by the fifteenth of August, (a) provided tenants can be obtained for the remainder of the season, the loss sustained is the rental value of the property for three and one-half months, viz $3,500; (b) were it impossible to obtain such tenants, the loss would continue for the whole season and would amount to $5,000.

Case III. The property is so damaged by fire that one-half of it is rendered untenantable from July 1st to September 1st. If tenants can be obtained for the one remaining month of the season the loss is (a) $1,000, otherwise, (b) $1,500.

Case IV. The property is destroyed or damaged by fire October the fifteenth. Since the property can be rebuilt or repairs can be made before the beginning of the next season (May 1st) there is no loss.

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[62] The same sort of loss would arise were the property only damaged by a fire occurring at a later date so that repairs could be made by the fifteenth of August.

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	CASE IV
EASTERN FORM FOR SEASON RISKS "E" "It is hereby provided that if said premises or any part thereof, whether rented at the time or not, shall be rendered untenantable by fire or lightning occurring during the continuance of this policy, this Company shall thereupon become liable for the rental value of such untenantable portions. Loss to be computed from the date of fire or damage by lightning, until such time as the building could, with reasonable diligence and dispatch, be rendered again tenantable, although the period may extend beyond the termination of this policy.	$5,000 (100%) *limit $1,000 per mo.	$5,000 (100%)	(a) or (b) $3,500 (100%)	(a) or (b) $1,000 (100%)	0
In consideration of the reduced rate at which this policy is written, it is agreed that this Company shall not be liable, under this policy, for a greater proportion of any loss that may occur than the sum hereby insured bears to the rental value of the whole of said premises during the period for which liability is assumed under the succeeding paragraph. Total liability under this policy for any loss shall not exceed the sum insured by this policy, nor this Company's pro rata proportion of all insurance on rental value, whether other insurance covers against loss caused by lightning or not.	$4,000 (80%) *limit $800 per mo.	$4,000 (80%)	(a) or (b) $2,800 (80%)	(a) or (b) $800 (80%)	0
Liability under this policy is limited to loss of rental value sustained, not exceeding the rate of $ * per month, from May 1st to September 30th in each year, inclusive, and this Company is hereby relieved from all liability for loss of rental value during the remainder of the year, *i.e.*, from October 1st to April 30th in each year, inclusive." The amount of insurance required is $5,000.					

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	CASE IV
EASTERN FORM FOR SEASON RISKS "F". "It is hereby provided that if said premises or any part thereof shall be rendered untenantable by fire or lightning occurring during the continuance of this policy, this Company shall thereupon become liable for the rental value of such untenantable portions. Loss to be computed from the date of fire or damage by lightning and to cover only actual loss sustained under bona fide written lease or leases. In the event of it being possible to restore said premises to a tenantable condition prior to the expiration of the rental season, the company shall receive due credit for any recovery of rent thereby made obtainable, whether from the original lessee or other sources, in the adjustment of any claim under this policy. In consideration of the reduced rate at which this policy is written, it is agreed that this Company shall not be liable, under this policy, for a greater proportion of any loss that may occur than the sum hereby insured bears to the rental value of the whole of said premises during the period for which liability is assumed under the succeeding paragraphs. Total liability under this policy for any loss shall not exceed the sum insured by this policy, nor this Company's pro rata proportion of all insurance on rental value, whether other insurance covers against loss caused by lightning or not. Liability under this policy is limited to loss of rental value sustained, not exceeding the rate of $ * per month, from May 1st to September 30th in each year, inclusive, and this Company is hereby relieved from all liability for loss of rental value during the remainder of the year, *i.e.*, from October 1st to April 30th in each year, inclusive." The amount of insurance required is $5,000.	$5,000 (100%) * limit $1,000 per mo.	$5,000 (100%)	(a)$3,500 (100%) (b)$5,000 (100%)	(a)$1,000 (100%) (b)$1,500 (100%)	0
	$4,000 (80%) *limit $800 per mo.	$4,000 (80%)	(a)$2,800 (80%) (b)$4,000 (80%)	(a)$800 (80%) (b)$1,200 (80%)	0

IF THE RENT IS INSURED UNDER	TO THE EXTENT OF	THE INSURER'S LIABILITY WILL BE			
		CASE I	CASE II	CASE III	CASE IV
PACIFIC FORM 2. (See previous table.)—Insurance required is 100% of the annual rental value, viz., $5,000.	$5,000 (100%)	$5,000 (100%)	(a) or (b) $3,500 (100%)	(a) or (b) $1,000 (100%)	0
	$4,000 (80%)	$4,000 (80%)	$2,800 (80%)	$ 800 (80%)	0
SOUTHEASTERN SEASON RISK FORM.		Same as Eastern Form "E"			
MIDWESTERN FORM 4. (See previous table.)—No particular amount of insurance is required.	$5,000	$5,000 (100%)	(a) or (b) $3,500 (100%)	(a) or (b) $1,000 (100%)	0
	$4,000	$4,000 (80%)	$3,500 (100%)	$1,000 (100%)	0

Rent Insurance Rates.

1. *Basis for the Rate.*

An insurance rate should measure two things, (1) the frequency with which the hazard insured against occurs, and (2) the severity of the loss occasioned by the occurrence of the hazard. This measurement may be accomplished by the classification and analysis of statistical data gathered from past experience under the line of insurance in question. Unfortunately this has not been done for the business interruption insurance lines. Data relating to business interruption insurance losses have not been separately classified but have been combined with the direct damage insurance loss data of the hazard insured against. The Standard Fire Classification of the National Board of Fire Underwriters now consists of only 28 classes of fire hazards,[63] and provides that "Rent, Lease, Use and Occupancy, Commissions and Profit risks be given the same number as the classes to which they apply." Consequently in reporting their experience to the National Board the fire insurance companies combine the amount of the direct damage loss and the amount of any business interruption loss and report it as one loss chargeable to the particular occupancy classification. This does not prohibit an insurance company from keeping a more detailed classification in which it might separate its direct damage and its business interruption experience. Some companies, for their own information, have segregated their data upon business interruption lines, but it *is* solely for their own information and *is not* made available for rate construction purposes.[64] Other companies have data in such form that it could be segregated easily if the occasion demanded, but so long as the demand for business interruption lines is becoming

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[63] Prior to January 1, 1928 there were 164 classes.

[64] Out of 123 of the 200 largest stock fire insurance companies in 1927 only 11 companies had segregated data for rent and leasehold insurance, only 16 companies had segregated data for use and occupancy insurance, and only 9 companies had segregated data for profits and commissions insurance. Out of 89 of the 100 largest mutual fire insurance companies, 47 did not write business interruption insurance lines, many of the rest wrote only very little, and only 5 companies had their data segregated.

greater and greater, and so long as a profit is realized from them, there is sufficient incentive for the insurance companies to let well enough alone.

Because of this lack of adequate data business interruption rates in general and rent insurance rates in particular, are based upon the direct damage insurance rate. The fire insurance rate is presumed to measure the frequency with which fires occur and the severity of the damage done by fires. The rent insurance rate should measure the frequency with which premises are rendered untenantable by fire and the severity or degree of the loss of rent. The frequency with which fires occur determines the frequency with which rent losses occur. But the severity rates of rent insurance losses are not of necessity dependent upon, nor proportionate to, the extent of the direct damage done. A small property loss may be the cause of an extraordinarily large loss of rent and, vice versa, a large property loss might carry with it only a small loss of rent. In view of these possibilities, and in the absence of any evidence to support a conclusion that there is in general a direct relationship between the extent of the direct damage done by a fire and the loss of rents resulting therefrom, it must be admitted that the use of the fire insurance rate as a base for rent insurance rates may be unreliable.

2. *Rates for the Eastern Forms.*

Rates for the Eastern forms are provided as set forth in the schedule on the following page:[65]

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[65] *Eastern Underwriters' Association Rules.* Edition of 1927 corrected to January 1, 1930. Rule 53, p. 58. The different associations having immediate jurisdiction over the territory depart from these specific rates but retain the same principles.

SCHEDULE OF RATES FOR RENT INSURANCE

FORM	UNDER PUBLIC PROTECTION OR SPRINKLER PROTECTION		
	X WHERE CO-INS. RATE IS PROVIDED	Y WHERE CO-INS. RATE IS NOT PROVIDED	Z IF RISK IS NOT PROTECTED
"A" Rented or vacant, based on time required to rebuild.	Co-ins. rate for building.	30% off flat building rate.	Flat rate for building.
"B" Rented only, based on time required to rebuild.	5% off Co-ins. building rate.	33⅓% off flat building rate.	5% off flat rate for building.
"C" Rented or vacant, based on annual rental.	20% off Co-ins. building rate.	45% off flat building rate.	15% off flat rate for building.
"D" Rented portions only, based on annual rental.	30% off Co-ins. building rate.	50% off flat building rate.	20% off flat rate for building.
"E" Seasonal Risks, Summer or Winter cottages, etc.	20% off Co-ins. building rate.	45% off flat building rate.	15% off flat rate for building.
"F" Do.	Co-ins. rate for building.	30% off flat building rate.	Flat rate for building.

The co-insurance rate referred to in Column X shall be based upon 80% or higher co-insurance without deduction for any higher percentage.

If the property used to illustrate the adjustment of rent insurance losses[66] had been specifically rated, and the 80 per cent coinsurance fire insurance rate had been $1.00 per $100 of insurance,[67] the rent insurance rates and premiums on the amount of insurance required for full coverage under the different forms would have been as follows:

FORM	RATE	INSURANCE REQUIRED	PREMIUM
"A"	$1.00	$8,000	$80.00
"B"	.95	6,400	60.80
"C"	.80	12,000	96.00
"D"	.70	9,600	67.20

Form "A" and Form "C" are comparable in their coverage, as are forms "B" and "D". In this case the insured would

[66] See p. 92. Seasonal risks are considered later.

[67] See Column X. Rates on the different forms, where no coinsurance rate is provided, (Column Y) are approximately the same provided the coinsurance rate amounts to about 70 per cent of the flat rate.

have preferred Form "A" over Form "C" had he desired to cover the rental value of his entire premises, whether rented or vacant at the time of the fire, for though either form would have provided him with equally complete protection, Form "A" was considerable less expensive. Likewise, had he desired to cover only the rental value of the occupied portions of the premises he would have preferred Form "B" over Form "D" because of the saving in premium without the sacrifice of any protection. This preference results from the fact that the premises can be rebuilt within eight months. In any case where beyond question the property can be rebuilt in less than 9.6 months, Form "A" provides equally as complete coverage less expensively than Form "C". In any case where the property can be rebuilt in less than 8.8 months, Form "B" is to be preferred over Form "D". The only justification for this difference in cost between forms which provide identical coverage is that it is difficult to estimate accurately the length of time which may be required to rebuild a property. Conditions may change so that a property which ordinarily could be rebuilt in six months may require a longer period for its restoration. In such a case full recovery of his loss could not be obtained by an insured were he covered under Form "A" or Form "B" for only six months' rental value. But assuming the continuance of normal building conditions the differences in rates between forms identical in their coverage are unsupportable. It was previously pointed out[68] that the difference in rates charged for Form "A" as contrasted with Form "C", and Form "B" as contrasted with Form "D", was designed to reconcile the difference in coinsurance provisions of these forms. As is evident, the rate differential does not and can not effect this reconciliation.

That a coinsurance provision based upon the annual rental value of a property is open to criticism unless allowance is made in the rate charged for risks requiring different periods of time for their rebuilding, may now be demonstrated. Consider two properties each of which produces a rent or rental value of $1000 per month. Each carries an 80 per cent coinsurance fire insurance rate of $1.00. The first property is con-

[68] See p. 84.

structed in such a manner that it can be rebuilt within six months, the second within one year. Even though conditions changed so that more time would be required to rebuild them, the latter would require relatively twice as long a period as the former. While both properties present equal fire risks (as evidenced by the equality in their fire insurance rates), they are totally different rent risks, the difference being one of size. Nevertheless, if they are insured under Form "C" or Form "D", which require insurance to the full annual rental value, both risks will be required to be insured to the same extent ($12,000) and at the same rate ($.80 under Form "C" or $.70 under Form "D".) Were these risks insured under Form "A" or Form "B" the difference in the risks would be recognized by requiring only one-half as much insurance at the same rate, and thus requiring only one-half as great a premium, in the former case as in the latter. The only type of rate adjustment which would render forms which require insurance based upon the annual rental value relatively equal in cost and coverage as between different risks would be one in which the rate would be made to depend directly upon the period which would be required to rebuild the property if totally destroyed. This, however, would be tantamount to writing the policy with a coinsurance provision based upon the rental value of the property for the time required to rebuild.

Another illustration of the empirical character of the rent insurance rate structure is found upon comparing the rate reductions granted when the coverage of the policy is restricted to the loss of rental value from rented portions of the premises only. Form "D" differs from Form "C" and Form "B" differs from Form "A" only in this one respect, nevertheless the rate on Form "D" is 12.5 per cent less than that of Form "C", while the rate on Form "B" is only 5 per cent less than that on Form "A". Rates for seasonal risks are subject to the same criticisms as those directed against the rates for Forms "C" and "D" on ordinary risks. The requirement of the seasonal forms that insurance be carried to the amount of the rental value of the premises during "the time for which liability is assumed" under the policy is, in effect, the same as requiring insurance

to the amount of the full annual rental value, since the rental value derived from a property during its entire operating season will be its annual rental value. It is impossible to write seasonal risks upon any other coinsurance basis, the rental value of the risk for the period of time required for its reconstruction being indeterminate. Instead of writing all seasonal risks at the same proportion of the fire insurance rate differences in the period of time required to rebuild different risks should be considered. This could be done by graduating rates on different risks in proportion to the time necessary for their restoration and applying the rate to the average amount at risk under the policy.

3. *Rates for the Pacific Forms.*

Rates for the Pacific forms have been promulgated as follows:[69]

"REDUCED RATE AVERAGE CLAUSE

The term 'Building Rate' for rentals means the rate chargeable without any deduction for reduced rate average clause.

With	50%	reduced	rate	average	clause,	75%	of	building	rate,
"	60%	"	"	"	"	70%	"	"	"
"	70%	"	"	"	"	65%	"	"	"
"	80%	"	"	"	"	60%	"	"	"
"	90%	"	"	"	"	55%	"	"	"
"	100%	"	"	"	"	50%	"	"	"

Unless at least the 50% clause is included in the form the full building rate applies."

If the form covers the rental value of vacant portions of the building the rate "shall be the gross rate of the building plus 25 per cent, and the form under which such policies are written shall require the 100 per cent reduced rate average clause; no reduction therefor."

The use of a so-called "50 per cent reduced rate average clause" on a risk which would require six months for its rebuilding, or the use of a "100 per cent reduced rate average clause" on a risk

[69] *Board of Fire Underwriters of the Pacific Tariff Rules*, June 1926, p. 17.

which would require one year for its rebuilding is, from the standpoint of the protection afforded, the equivalent of the use on either of these risks of Eastern Form "B", which requires insurance to the full amount of the rental value for the time required to rebuild. But from the standpoint of the rates for the forms they are radically different. Eastern Form "B" would be written on either risk at 66 2/3 per cent of the building rate,[70] but under the Pacific forms the risk using the "50 per cent reduced rate average clause" would be required to pay a rate of 75 per cent of the building rate upon the same amount of insurance as that required under Eastern Form "B", whereas that using the "100 per cent reduced rate average clause" would be required to pay a rate of only 50 per cent of the building rate upon the same amount of insurance as that required under Eastern Form "B".

The question which arises is whether both the amount of insurance required and the rate should vary as the time required to rebuild a property varies, or should only the amount of insurance required vary. To answer the question properly a volume of rent loss data is necessary since to reach a conclusion deductively, unsupportable assumptions must be made. It is sufficient here to point out that the Pacific system, which allows both a variation in the amount of insurance required and in the rate for the form, without reference in either case to the time required for restoring a risk, is subject to criticism. While a "50 per cent reduced rate average clause" is particularly adapted to a risk which requires six months for its rebuilding, such a clause may be used on any risk regardless of the time so required. Consider again two risks, each producing $1000 per month rent, each bearing a fire insurance rate of $1.00, and similar in all respects save that the former will take one year to rebuild and the latter six months. If the rent insurance on each is written with a "50 per cent reduced rate average clause" $6000 insurance will be required at a rate of $.75. Thus for the same premium, $45, each risk has full protection against all

[70] Assuming no coinsurance rate on the building has been provided, so that the risk may be on the same basis as that upon which Pacific form rates are based.

losses up to a total of $6000. Just as in direct damage insurance, there is bound to be a preponderance of small losses in rent insurance. Since it is manifestly improper to write a $6000 fire insurance policy promising to pay all losses in full on a $12,000 risk for the same premium as a $6000 fire insurance policy on a similar $6000 risk, it is equally improper to use the same percentage "reduced rate average clause" under the Pacific forms of rent insurance to cover two such rent risks. Just as it would be in fire insurance, the smaller risk would be discriminated against, and this discrimination would be magnified under the Pacific system by allowing a further reduction in rate as the amount of insurance on a larger risk increased.

The decrease in rate is not the sort of decrease allowed under a graded rate system. A plan of graded rates would provide for payment of all losses in full up to the face amount of the policy and allow decreases in the rate as the amount of insurance carried increased in proportion to the insurable value of the risk. Similar risks, insured to the same percentage of value, would carry the same rate. But this is not the case under the Pacific system. Here the reductions in rate are allowed as the coinsurance percentage increases in its proportion to the annual rental value of the risk, and not as the amount of insurance actually carried increases. As has been established earlier in this Chapter,[71] the relative insurable values of rent insurance risks are not properly measured by the annual rental values of the properties, but by the rental value for the time which would be required to rebuild each risk.

4. *Rates for the Southeastern Forms.*

Since four of the Southeastern forms correspond to the four Eastern forms for ordinary risks[72] their rates will be subject to the same criticisms as those to which the Eastern rates were subject. Likewise, the additional forms for ordinary risks correspond to the Pacific forms using "50 per cent and 75 per

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[71] See pp. 83–84.
[72] See pp. 87–88.

cent reduced rate average clauses,"[73] and the rates on these may be similarly criticized. By comparing the rates of the Southeastern forms[74] with the rates of the corresponding forms in other jurisdictions, the charge that rent insurance rates are assessed empirically may be further substantiated. The forms corresponding to Eastern Forms "A" and "B" are written at the same rates as in the Eastern territory, that is, 100 per cent and 95 per cent of the building rate respectively. But the forms corresponding to Eastern Forms "C" and "D" are written at 75 per cent and 95 per cent of the building rates respectively, as compared with 70 per cent and 80 per cent of the building rate in the Eastern territory. It is impossible to compare the rates on the Southeastern forms with the rates on the corresponding Pacific forms, for the Southeastern building rates are coinsurance rates whereas the Pacific building rates are flat rates without allowance for coinsurance.

In the writing of seasonal risks it is provided that the seasonal form "may be written at short rates of the annual rate, but in no event for a period of less than three months."[75] In the Eastern territory the writing of seasonal risks at short rates of the annual rate is prohibited specifically.[76] Such a prohibition is theoretically and practically sound, and its waiver in the Southeastern territory is entirely unjustifiable. The term of insurance under a seasonal policy is one year regardless of the limitations placed upon the period of indemnity. Since it is the loss of rent occasioned by a fire occurring any time within the year, rather than only that rent loss resulting from a fire occurring within the season during which the property is utilized, which is insured against, the rate to be charged must be an annual rate rather than a short rate.

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[73] See p. 88.

[74] *Southeastern Underwriters' Association "Standards"*, revised to September, 1928, pp. 129–131.

[75] *Ibid*, p. 130-A.

[76] *Eastern Underwriters' Association Rules*, revised to January, 1930, p. 38, Rule No. 53(b).

5. *Rates for the Mid-Western Forms.*

In the Midwestern territory the first basis for classifying rent insurance rates depends upon whether the policy includes or excludes a limitation upon the insurer's monthly liability under the policy. If the policy is free from any restriction,[77] the rate charged is the gross building rate without any allowance for the use of a coinsurance clause in writing the direct damage insurance. Since this rate applies regardless of the amount of insurance carried and regardless of the length of time over which the premises may remain untenantable, it permits the writing of risks with neither coinsurance nor graded rate provisions, and consequently may produce inequity between different risks.

If the amount of loss per month which may be claimed under the policy is limited to a stated proportion of the amount of the policy, rates are made to depend (1) upon the particular limit imposed in the policy and (2) upon whether the property is classified as fireproof or non-fireproof. If the property is not fireproof, forms may be written only with a limit of one-ninth or one-twelfth. If the property is fireproof, any limit from one-sixth to one-twelfth may be used. If the property is not fireproof the reductions in rate depend also upon the extent of the coverage of the policy, *i.e.*, whether the rental value of the entire premises[78] or only that of the portions occupied at the time of the fire[79] is covered. If the property is fireproof,[80] reductions in rate depend solely upon the limit of liability of the form. Since there is no difference in rates based upon the coverage of the form, the broader form covering the rental value of the entire premises always will be used on fireproof risks. On non-fireproof risks separate reductions in rate are provided for fire hazards and tornado hazards. On fireproof risks the reductions are granted for combined fire and tornado coverage.

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[77] Form No. 4.
[78] Form No. 2.
[79] Form No. 1.
[80] Specific rates are promulgated for sprinklered risks or risks for which only coinsurance fire rates are provided.

RENT INSURANCE RATES[81]—MIDWESTERN FORMS

LIMIT OF LOSS PER MONTH	NON-FIREPROOF				FIREPROOF
	OCCUPIED ONLY		ENTIRE PRMISES		
	FIRE	TOR-NADO	FIRE	TOR-NADO	FIRE AND TORNADO
Not exceeding one-sixth	—	—	—	—	53%
" " one-seventh	—	—	—	—	58%
" " one-eighth	—	—	—	—	62%
" " one-ninth	—25%	—44%	—15%	—44%	65%
" " one-tenth	—	—	—	—	67½%
" " one-eleventh	—	—	—	—	70%
" " one-twelfth	—40%	—55%	—30%	—55%	72%

The following additional facts may be gathered from the above table. First, that reductions in rate are greater as the insurer restricts its liabilitythe more, and second, that reductions in rate are greater for fireproof risks than for non-fireproof risks. It is to be expected that the more the insurer limits its liability the lower the rate at which it can issue coverage, but whether the given decrease in rate correctly measures the lessened liability of the insurer, is not determinable. Since the system itself has been handicapped by existing anti-coinsurance legislation and since the system of rates is not a graded rate system, absolute justice in rates can not be realized. The substantial reductions in rate for fireproof risks can be supported only on the assumption that rent losses are proportionately less severe than direct damage losses on fireproof as contrasted with non-fireproof risks, an assumption which lack of statistical evidence makes unprovable.

Conclusions as to Rent Insurance.

Lack of uniformity between different sections of the country and lack of adequate statistics upon which to base rates, are the

[81] Rates are quoted as percentage credits from the flat building rate. See Rule Book of any Midwestern Bureau. The quoted rates were tabulated from those of the *Ohio Inspection Bureau Rule Book*, pp. 51–52, revised to October 10, 1928.

outstanding defects of our present rent insurance scheme. The method of writing rent insurance in the Eastern territory has more to recommend it than have any of the other systems, consequently its nation-wide use would be a step forward. Because of legislative obstructions in the Midwestern territory, such a goal is unobtainable until these obstructions are removed. In the other territories, the Eastern system of rent insurance could be inaugurated without difficulty. With uniform forms in use, a sufficiently large volume of data probably could be gathered and properly classified so that rent insurance rates could be independently determined. This separate classification and analysis of rent insurance experience would add to the expense of writing this line of insurance. To what extent additional expenses should be incurred in order to secure greater justice in rates is a question of judgment. Too minute a division of experience defeats its own end, for it may prove unreliable. A generally lower scale of less equitable rates may be preferred to the necessarily higher but more equitable rates which might be developed. But rates could be made to depend upon the length of time which, under normal circumstances, would be required to rebuild a risk, a most important factor which is now completely ignored in all except those forms in which the required amount of insurance is based upon the length of this period. Without such a modification in rates the Eastern forms which require insurance based upon the annual rental value of a risk can not be favored over those requiring insurance to the amount of the rental value for the time which would be required to rebuild, in spite of the difficulty of estimating such time. With such a modification in rates, each type of form could be rendered equivalent to the other,[82] and being superfluous, one could be abolished. The retention of the annual rental value forms would be preferable for, while in many cases more insurance would be required than the amount which at most could be lost, it would allow all risks to be written on the same basis and would require less troublesome classification of rent loss experience.

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[82] Except for risks requiring more than one year for their rebuilding, in which case a larger amount of insurance would be required in order that a total loss could be paid in full.

Leasehold Interest Insurance

Insurance covering the different types of leasehold interests previously described[83] is effected by attaching a special form to a standard fire[84] insurance policy form. Since the interest insured can not be possessed by the owner of the property this insurance can not be combined with the direct damage insurance on the property itself, but must be written separately.

The Extent of Uniformity in Forms.

The writing of insurance covering leasehold interests is relatively free from restrictions on the part of the various underwriters' associations or rating bureaus. As a result of this freedom there is much less precise uniformity in the forms used than is the case with rent insurance. For example, in the Eastern territory no standard forms are provided, each insurer being allowed to use whatever type of forms it desires.[85] Hence a multiplicity of forms has been developed, but upon comparison it is found that these forms are fairly uniform in their essential elements. Leasehold insurance does not lend itself to a great variety of underwriting methods such as are found, for example, in the field of rent insurance. Since cancellation of a lease will always produce a total loss of the leasehold interest, and since it is principally against loss caused by cancellation of a lease that this insurance is intended to protect, the problems to which partial losses usually give rise are avoided almost entirely. Once the insurable interest and its value have been established, the writing of the form is relatively simple.

In the Midwestern territory, however, the various rating bureaus have adopted uniform rules which provide for the incorporation of certain features in all forms used for the insuring

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[83] See pp. 38 to 45, Chapter 2.

[84] Coverage also may be obtained against other hazards where the lease may be canceled upon the destruction of or damage to the property resulting from such other hazards.

[85] The Eastern Underwriters' Association rules provide only that: "Policies covering leasehold interest shall be written at the rate applying to the building, unless otherwise rated for a special form of the contract."

of leasehold interests. In accordance with these requirements a "uniform standard" form has been drawn up and is exclusively used.[86] In the Pacific territory several clauses are made mandatory but no special forms have been published.

Uniform Provisions of the Forms.

In the writing of leasehold interest insurance, it is essential that the insurer know the conditions under which the lease may be terminated. Every form provides for the insertion of a copy of the "fire clause" of the lease, so that this clause may become a part of the contract of insurance. It is provided further, under penalty of voidance of the insurance, that no change may be made in the clause without notice to, and consent of, the insurer. If, for any reason, the "fire clause" is modified or added to, the change may be endorsed upon the policy and the necessary adjustment of the premium made. If the lease contains no fire clause it is sometimes provided in the policy that "the statutory requirements of the State in which the property is situated shall govern."[87] Since the insurer is not a party to the contract between the lessor and the lessee, this provision is of no effect in determining the lessor's right to cancel the lease. But usually it is the law of the State in which the property is located by which the courts determine the respective rights of the parties to the lease, consequently a stipulation to this effect in the policy determines the lessee's rights under the insurance contract by the same rules as those which fix his status under the lease.

Leasehold interest insurance forms also contain a clause which seeks to limit the insured's right of cancellation of the insurance. Except for minor differences in wording, the clauses uniformly provide that in consideration of the special rate at which the contract is written the insured may not cancel the policy for the purpose of rewriting it for a term extending beyond the date of expiration named in the policy, nor for the purpose of rewriting

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[86] In Ill., Ind., Kan., Ky., Mich., Mo., Neb., N. Dak., Ohio, Okla., S. Dak., Tenn., Colo., Wyo., and New Mexico. It is used also in Iowa with slight modification.

[87] See the "Uniform Standard" Form in use in the Midwest.

it for a smaller amount. The intention of this provision may be shown by an illustration. If a leasehold interest of $100 per month for the remaining five years of the term of the lease is insured under a policy with a term of one year, the insured has protection to the extent of $6000 at the time the policy is issued.[88] After six months have passed the value of the leasehold interest would be but $5400, the risk of the insurer being correspondingly reduced. This reduction in risk has been considered in the determination of the insured's premium. If he could now cancel and rewrite the policy for the term of a year from the present time, receiving back the excess of the premium over the customary short rate for the expired term, the insurer would be at a disadvantage. Since the insurer's risk is greater in the earlier months of the term of the policy, a greater proportion of the premium is earned during these earlier months than is allowed under short rate tables. The insurer's risk for the year decreases from $6000 at first to $4900 during the last month of the policy term, averaging for the year $5450. But during the first half of the year, its average risk has been $5750. Short rate tables allow retention of portions of the premium based upon the assumption that the risk has been uniform in size throughout the year. Since this is not the case in leasehold insurance, cancellation of the policy by the insured for the purpose of rewriting it for a term extending beyond its original date of expiration, or for the purpose of rewriting it for a reduced amount,[89] is prejudicial to the interest of the insurer and is prohibited. It is questionable, however, whether such a cancellation provision can be made effective. Since an insured has a right to cancellation without a statement of reasons, it would seem that he could cancel regardless of whether he had or had not the intentions stated above. He could then apply for insurance in another company and accomplish the prohibited purpose. To protect itself properly the insurer should incorporate a clause into its contract to the effect that upon cancellation of the policy, the earned

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[88] To simplify the illustration, the question of discounting the leasehold value is ignored. This does not affect the validity of the argument.

[89] Unless there has been a decline in the leasehold value per month. In this case the right of cancellation is allowed.

premium should be computed upon the average amount of insurance for the expired time, pro rata if the company cancels, or at short rates if the insured cancels.[90]

Types of Policies.

There is a need for only one type of leasehold interest form, though two are in actual use: one to cover interests which arise out of the payment of a bonus to obtain a favorable lease, another to cover leasehold value or leasehold profit interests. Originally, leasehold forms were written with provision for the payment of the full amount of the bonus paid for a lease or of the full amount of the leasehold value or profit without discount, the same type of form being applicable to any case. How such forms originally came into use can not be determined. It is certain, however, that they were used until recent years.[91] If the interest insured were that of a lessee possessing a leasehold profit of $1,200 per year for a period of the ten remaining years of the term of the lease, the policy would be written for the amount of $12,000, and would provide for its reduction at the rate of $100 per month for each month of its term. If a fire, which allowed the lessor to cancel the lease, occurred after one year had elapsed, the insurer promised to pay the lessee the full amount of the policy then remaining in force. Thus, the lessee would receive $10,800, the amount to which the insurance had been reduced, or the undiscounted amount of the leasehold profit for the remaining nine years at the rate of $1200 per year. Giving the lessee the full amount of his leasehold profit at once, which in the ordinary course of events would have accrued to him only over the term of the ensuing nine years, was a simple case of over-indemnity. The maximum amount which should be paid under such circumstances is the present value of an annuity of $100 per month for a period of 108 months, discounted at an agreed upon rate. The present value of $1 per month for 108 months at 4 per cent discount compounded annually is $90.8483.

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[90] Such a clause is found in the Midwestern form.

[91] Copies of such leasehold forms appear in R. P. Barbour's *Agent's Key to Fire Insurance*, Spectator Company, 1922 Edition, pp. 361–363.

Consequently the lessee should recover only $9,084.83 instead of $10,800 in order that he may be fully indemnified.

This principle was unrecognized until recent years, but it is now universally applied to the insurance of leasehold value or profit forms. Its application to a form which covers a lessee's interest arising out of the payment of a bonus for a favorable lease, is not so apparent, and policies are issued now which provide for the payment of the full amount of the bonus with a pro rata deduction for the amount of it which has been earned over the period which has expired since the purchase of the lease. Instead of producing over-indemnification of his loss, the purchaser of a lease is prevented from recovering the full amount of his loss. In the preceding illustration, the amount of the monthly leasehold profit was known, but its present value remained to be determined. On the assumption that 4 per cent per annum was a fair rate of discount, its present value, when it had nine years still to run, was $9,084.83. This is the amount which one could afford to give to the lessee for the privilege of taking over the existing lease and sub-leases. In other words, it is the amount of the bonus which could properly be paid. The bonus represents the present value of the leasehold value or profit of the lease, and the payer of a bonus is in no different position from that of the possessor of a leasehold value or profit. In this case it is the present value of the leasehold value or profit which is a known quantity and the monthly leasehold value or profit remains to be determined or disclosed. This can be found to be $100 per month by dividing the amount of the bonus by the present value of $1 per month for 108 months at 4 per cent discount compounded annually. If the purchaser of the lease is to earn a return of 4 per cent per annum on his investment of $9,-084.83 and reimburse himself for his outlay by the end of the term of the lease, he must clear $100 per month. If, then, a fire occurs at the end of two years and the lease is cancelled, the insured, to be fully indemnified, must be paid that amount which at 4 per cent interest per annum will produce $100 in each of the remaining eighty-four months and liquidate itself in the process. This may be found to be $7333.59. Were the bonus of $9084.83 insured under a form which provided for the payment of

the full amount of the insurance reduced at the rate of 1/108th of its amount per month ($84.12), the insured would receive only $7,065.95. This discrepancy results from the fact that the right of the insured to earn a fair return on his investment is ignored. The liquidation of the bonus may be likened to the accumulation of a sinking fund. While the contribution to the sinking fund is uniform month by month, the fund itself grows at an ever-increasing rate. Likewise, the purchaser of a lease by setting aside a uniform sum each month, liquidates a smaller proportion of his investment in the earlier years. Hence, while the insurance policy should decrease in amount month by month it should not decrease uniformly, but by an increasing amount as time goes on. This can be accomplished only by applying the same principle to a policy covering a bonus as that which is applied to policies covering other leasehold interests—that is, paying the discounted present value of the lease. While the method of insuring leasehold bonuses results in under-payment of the amount of any loss and is not to be viewed with the same degree of alarm as that of a scheme which permits over-payment, it should be changed to this more accurate plan which allows complete indemnity.

Policies which cover leasehold values or profits are written upon two different types of forms in different sections of the United States. From the standpoint of the indemnity promised, these forms offer identical protection, each paying as the amount of a loss the discounted present value of the leasehold value or profit insured. But in the amount of insurance for which the form shall be written they differ materially. One type of form, which is used in the Eastern section and which may be used in the Pacific territory, requires insurance for the full undiscounted amount of the leasehold value or profit for the remaining term of the lease. It then provides that the amount of the policy shall be automatically reduced as time goes on in the proportion that the interest of the insured as lessee decreases. But in the event of loss it provides that the insured shall recover only that amount which at 4 per cent interest compounded annually would be the equivalent of the lessee's interest as it would have accrued monthly for the remaining term of the lease. Under

this type of form the insured never can recover immediately the full amount of the insurance carried. If, as in the illustration previously used, a lessee has a leasehold value or profit of $100 per month under a lease with ten years still to run, it would be necessary to carry $12,000 of insurance. If a fire occurred immediately and the lease were cancelled, the insured could recover—not the full amount of insurance, but his actual loss—the present value of the leasehold value or profit discounted at 4 per cent, viz., $9910.37. If the fire occurred after one year had passed, the amount of insurance would have been reduced to $10,800, but the insured could recover only $9084.83, this, however, being his actual loss.

The other type of form which is always used in the Midwestern territory and usually also in the Pacific territory requires insurance only to the discounted present value of the leasehold value or profit for the remaining term of the lease. It then provides for the automatic reduction of the policy "as set forth opposite each respective month in the net leasehold interest table which accompanies this policy form . . . "[92] In the event of a loss it provides for the payment of the "net leasehold interest" which is defined as "that sum which placed at 4 per cent interest compounded annually will be equivalent to the interest of the insured as lessee for each separate month of the lease unexpired." In accordance with the terms of the policy, the above risk would be written for an amount of $9910.37,[93] and this amount would be payable if a loss occurred immediately. If the loss occurred after one year had passed the amount of insurance would have been reduced to $9084.83, and this amount would be paid to the insured. It is evident that this method

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[92] Midwestern standard leasehold form. The wording of this provision is subject to criticism, but when the provisions of the insuring clause are considered its meaning becomes clear. It is not the intention of the provision to reduce the amount of insurance at the end of the first month by the discounted value of $1 due one month hence, i.e. $.9967 as set forth in the table, but rather by the discounted value of $1 due 120 months hence (if the lease has 10 years still to run), i.e. $.6756 as set forth in the table opposite the 120th month.

[93] Except for the fact that the policy provides for the coverage of the interest insured free from discount for the first three months, consequently each amount stated should be increased by $1.95.

of covering leasehold interests is preferable, though the Eastern plan is simpler in application to risks on which no loss occurs, it being necessary to explain the system of discount only to those who experience a loss.

Additional Coverage Under Leasehold Forms.

While the primary purpose of leasehold insurance is to guarantee the lessee against loss resulting from the cancellation of the lease as a result of the hazard insured against, policies also provide coverage for the loss of leasehold value or profit which results from the untenantability of the premises which is not sufficiently serious to necessitate a cancellation of the lease. If the fire clause of a lease provides that it may be cancelled only upon the occurrence of damage to the premises to the extent of 75 per cent or more of its value, a fire which causes damage of only 50 per cent of its value will not allow cancellation of the lease. But the lessee is in the position of not being able to realize the full value due him from the property until such time as it has been repaired or rendered tenantable again. If he has sublet the premises at a profit of $100 per month he will lose this profit for each month of its untenantability regardless of whether or not he is relieved from the payment of rent to the lessor. If he is relieved from the payment of rent, his loss is limited to the amount of $100 per month until the premises are rendered tenantable again. If the necessity for paying rent to the lessor is not suspended, his loss consists of two parts: (1) the loss of rent which he must pay, and (2) the loss of his leasehold profit or value. To cover the first loss he must carry rent insurance of one of the previously described types. It is only the second loss which the leasehold policies are extended to cover.

The clause of the policies which provides for the indemnification of such a loss states that, "If by fire occurring during the term of this policy, the above described premises are damaged, which damage does *not* cause a cancellation of the lease in accordance with its terms and conditions, but does render the premises untenantable in whole or in part, this company shall

be liable for its pro rata proportion of the actual loss sustained by the insured to his interest as lessee, at the rate of not exceeding $\$\ldots$ per month for total untenantability, or a pro rata proportion thereof for partial untenantability, for and during such time, but not beyond the expiration of the lease, as may be necessary with the exercise of reasonable diligence and dispatch to restore the premises."[94] In forms similar to those used in the East the blank in the above clause would be filled in for the pro rata amount of insurance per month, *i. e.*, the face of the policy divided by the number of months of the unexpired term of the lease. In the Midwestern forms, and in most of the Pacific forms, the amount filled in would be the amount of the monthly interest of the lessee *without discount*, and hence not equal to the face of the policy divided by the number of unexpired months of the lease.

The clause effectively applies a 100 per cent coinsurance requirement by limiting the amount of indemnity recoverable first, if the premises are rendered totally untenantable, to the specified portion of the total insurance per month, and second, if the premises are rendered only partially untenantable, to a pro rata proportion of the limit allowed for total untenantability. Thus, if the leasehold value or profit insured is $100 per month, the insured must carry insurance to that extent in order to recover these partial losses in full. If he only carries such an amount of insurance as would produce a monthly limit of $50, only one-half of his losses would be paid. Suppose that the premises are rendered totally untenantable for two months. The insured's loss is $200 but his recovery is limited in the policy to the amount of $50 per month. He is carrying only 50 per cent insurance and is indemnified only to that extent. Suppose, on the other hand, that the premises are rendered untenantable only to the extent of 25 per cent for the ensuing two months. The insured's loss is now $25 per month, or $50 in total. Under the terms of the policy his right to recovery is limited to a pro rata proportion of the amount of the limit allowed for total

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[94] The clause quoted is taken from a policy used in the East. Clauses in other policies differ only slightly in wording.

untenantability, viz., 25 per cent of $50, or $12.50 per month for each of the two months.

Leasehold Insurance Loss Adjustments—Procedure.

To establish the fact that there has been a loss of leasehold value or profit it is necessary to prove, first, that there existed a value or profit in the lease, and that the lease was cancelled or that the premises were rendered untenantable. In proving the fact that a leasehold value or profit existed, the evidence produced will show also the extent of the existing value or profit. First, the lease, or contract under which the lessee's right to the property is determined, must be produced. From it may be determined the extent of the lessee's liability. If the lessee is liable only for rent, the amount of rent will be definitely stipulated; if he is liable not only for rent, but for other expenses, the nature of these expenses will be set forth in the lease but additional evidence will be necessary to prove their amount. This evidence will usually be supplied by examination of the lessee's books of account which must be produced, or, in the event of their destruction, by contracts or by cancelled checks which can be traced definitely. The same sort of evidence is necessary to prove an interest arising through the payment of a bonus for a lease, the evidence being necessary to show the amount and the time of the payment.

The next step in proving the existence of a leasehold interest depends upon whether the lessee occupies the premises himself or whether they have been sublet by him. If the premises are occupied by the insured lessee, it is necessary to produce evidence to support a claim that the value of the property to him is greater than the amount of his liability under the terms of the lease. This is a matter of estimating the rental value of the property, and will be established by estimates of competent real estate agents. But the problem is not as simple as that of determining the rental value of the property for rent insurance purposes[95] for in that case the present rental value of the premises

[96] Except when the loss is one resulting from untenantability of the property till repaired, and not from cancellation of the lease.

for a relatively short period of time in the future is all that would be necessary to determine. Leases which produce a leasehold value for the lessee may run for many years, and in determining the rental value of the property due consideration must be given to the particular provisions or privileges of the lease and the remaining length of its term. Thus, if a lease still has ten years to run the question which must be answered is, for what amount could identical premises be obtained under a ten-year lease with identical provisions? This may be quite different from the amount for which identical premises could be obtained under a similar lease of shorter or longer duration. The best method of determining this value is to obtain the expression of competent real estate agents as to what they would be willing to pay for such a lease or for what amount they would offer a similar lease.

If the interest is that of a leasehold profit it is necessary to produce the sub-leases from which the value of the property in the form of income to the insured lessee may be determined. If the terms of the original lease and of the sub-leases are the same except for the stipulated amounts of rent the problem is simply one of subtracting the amount of the lessee's liability under the original lease from the amount of his income from the sub-leases. This establishes the leasehold profit per month, and it only remains for this to be properly extended for the remaining term of the leases. But where the provisions of the sub-leases are at variance with those of the original lease or with those of each other, particularly with reference to the lengths of their terms, many interesting problems may arise. The lessee's profit is established only for the lesser term or terms of the sub-leases. Beyond such times his interest is not that of a profit but that of a leasehold value. Hence, if the original lease still has ten years to run and a sub-lease of a portion of the property will expire in two years, the value which must be estimated[96] (in addition to the established profit for the ensuing two years) is the present value of an eight-year lease on a portion of a

[96] Except when the loss is one resulting from untenantability and not from cancellation of the lease.

property which will not be available for use until two years hence.

Next it is necessary to show that the premises have been rendered untenantable or that the lease has been cancelled. If the loss is one resulting from untenantability, it is not necessary to determine whether the lessee's liability for rent continues or is abated, for the amount of his rent is not being insured, but only the excess of the value of the premises over the amount of rent. The mere fact of untenantability caused by the hazard insured against is sufficient to establish a loss under the policy. Then, just as in rent insurance, the length of time which will be required to repair the damage done will be determined, and the amount of the actual loss established.

If the loss is one resulting from cancellation of the lease, the right of the lessor to cancel may be found by reference to the "Fire Clause" of the lease or, in the absence of any provision, by reference to the law of the state in which the property is located. If the fire clause is one which provides for cancellation by the lessor only if the damage amounts to a certain percentage of the value of the property, reliable estimates of the amount of the damage and of the value of the property must be obtained. If the lessor has effected a cancellation of the lease according to its terms, the copy of the fire clause in the insurance policy should be compared with that of the lease to see that no change has been made without the insurer's consent. If the lessor cancelled the lease under conditions which did not permit its cancellation legally, the lessee obtained a right of action against the lessor, but not against the insurer.

The adjuster has only one additional task, to determine the portion of the ascertained loss for which the insurer will be liable. If the lease has been cancelled, the loss will be a total loss and the whole amount of the insurance still in effect will be paid, so long as it is less than the ascertained loss. If more insurance is still in force than is necessary, the whole amount of the loss will be paid. If the premises were rendered untenantable but the lease continued, the insurer's liability will be arrived at under the terms of the clause in the policy which, in effect, applies

the 100 per cent coinsurance principle to such losses. This has previously been explained[97] and need not be repeated.

Leasehold Loss Adjustments—Illustrated.

When a leasehold value or profit is found to exist, the task of the adjuster is to find its present value at the time of the fire. To do this it is necessary to refer to a table giving the present value of an annuity at the rate of interest agreed upon in the policy. Such tables are available in many places, but most of them are upon an annual basis at rates of interest compounded annually or semi-annually. The insurer intends to pay, as indemnification for a loss, the present value of a monthly, rather than an annual, annuity, for that is the way in which rent usually accrues. Furthermore, the rate of interest specified in the policy is to be compounded only annually or semi-annually, not as frequently as the annuity itself is to accrue. As a result of this, the Midwestern policies, most of the Pacific policies, and many Eastern policies incorporate into the contract a table showing the present value of an annuity of $1 per month at the rate of interest compounded as specified in the contract. These tables usually consist of two parts, one giving the present value of each payment of $1 due from 1 to as high as 240 months hence, the other showing the total present value of the sum of 1 to 240 monthly payments. It is from this latter column of the table that the present value of the lease for the remainder of its term may be found at any time, if the monthly value of the lease is known. A copy of such a table follows.[98]

To illustrate the settlement of leasehold interest losses, assume that a property was leased at a monthly rental of $1000. When the lease had seven years to run the lessee decided to insure his interest. It was found that the premises could have been sublet for the remaining seven years at a monthly rental of $1250. Ten months later a fire occurred.

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[97] See p. 123.

[98] A slight error appearing in the table in the forms and quoted herein, has been corrected recently by the Chicago Board of Underwriters, but not by the other rating bureaus of the Midwest.

Months	Sum which will increase to $1 in given number of months at 4% compounded annually	Net Leasehold Interest and amount for which policy should be written per $1 of Monthly Gross Leasehold Interest for number of months of lease unexpired	Months	Sum which will increase to $1 in given number of months at 4% compounded annually	Net Leasehold Interest and amount for which policy should be written per $1 of Monthly Gross Leasehold Interest for number of months of lease unexpired.
1	.9967	1.00	48	.8548	44.3702
2	.9935	2.00	49	.8520	45.2222
3	.9903	3.00	50	.8493	46.0715
4	.9871	3.9871	51	.8465	46.9180
5	.9839	4.9710	52	.8438	47.7618
6	.9807	5.9517	53	.8410	48.6028
7	.9775	6.9292	54	.8383	49.4411
8	.9743	7.9035	55	.8356	50.2767
9	.9711	8.8746	56	.8328	51.1095
10	.9679	9.8425	57	.8301	51.9396
11	.9647	10.8072	58	.8273	52.7669
12	.9615	11.7687	59	.8246	53.5915
13	.9576	12.7263	60	.8219	54.4134
14	.9546	13.6809	61	.8192	55.2326
15	.9516	14.6325	62	.8166	56.6492
16	.9486	15.5811	63	.8139	56.8631
17	.9456	16.5267	64	.8113	57.6744
18	.9426	17.4693	65	.8087	58.4831
19	.9396	18.4089	66	.8060	59.2891
20	.9366	19.3455	67	.8034	60.0925
21	.9336	20.2791	68	.8008	60.8933
22	.9306	21.2097	69	.7981	61.6914
23	.9276	22.1373	70	.7955	62.4869
24	.9246	23.0619	71	.7929	63.2798
25	.9215	23.9834	72	.7903	64.0701
26	.9186	24 9020	73	.7877	64.8578
27	.9156	25.8176	74	.7852	65.6430
28	.9126	26.7302	75	.7826	66.4256
29	.9097	27.6399	76	.7801	67.2057
30	.9067	28.5466	77	.7776	67.9833
31	.9038	29.4504	78	.7750	68.7583
32	.9008	30.3512	79	.7725	69.5308
33	.8978	31.2490	80	.7700	70.3008
34	.8949	32.1439	81	.7674	71.0682
35	.8919	33.0358	82	.7649	71.8331
36	.8890	33.9248	83	.7624	72.5955
37	.8861	34.8109	84	.7599	73.3554
38	.8833	35.6942	85	.7574	74.1128
39	.8804	36.5746	86	.7550	74.8678
40	.8776	37.4522	87	.7525	75.6203
41	.8747	38.3269	88	.7501	76.3704
42	.8719	39.1988	89	.7477	77.1181
43	.8690	40.0678	90	.7452	77.8633
44	.8662	40.9340	91	.7428	78.6061
45	.8633	41.7973	92	.7404	79.3465
46	.8605	42.6578	93	.7355	80.0844
47	.8576	43.5154	94	.7379	80.8199

Months	Sum which will increase to $1 in given number of months at 4% compounded annually	Net Leasehold Interest and amount for which policy should be written per $1 of Monthly Gross Leasehold Interest for number of months of lease unexpire	Months	Sum which will increase to $1 in given number of months at 4% compounded annually	Net Leasehold Interest and amount for which policy should be written per $1 of Monthly Gross Leasehold Interest for number of months of lease unexpired.
95	.7331	81.5530	142	.6287	113.4413
96	.7307	82.2837	143	.6266	114.0679
97	.7282	83.0119	144	.6246	114.6925
98	.7259	83.7378	145	.6226	115.3151
99	.7235	84.4613	146	.6206	115.9357
100	.7212	85.1825	147	.6186	116.5543
101	.7188	85.9013	148	.6166	117.1709
102	.7165	86.6178	149	.6146	117.7855
103	.7142	87.3320	150	.6126	118.3981
104	.7118	88.0438	151	.6106	119.0087
105	.7095	88.7533	152	.6086	119.6173
106	.7071	89.4604	153	.6066	120.2239
107	.7048	90.1652	154	.6046	120.8285
108	.7026	90.8678	155	.6026	121.4311
109	.7003	91.5681	156	.6006	122.0317
110	.6981	92.2662	157	.5986	122.6303
111	.6958	92.9620	158	.5967	123.2270
112	.6936	93.6556	159	.5947	123.8217
113	.6913	94.3469	160	.5928	124.4145
114	.6891	95.0360	161	.5909	125.0054
115	.6868	95.7228	162	.5890	125.5944
116	.6846	96.4074	163	.5871	126.1815
117	.6823	97.0897	164	.5851	126.7666
118	.6801	97.7698	165	.5832	127.3498
119	.6778	98.4476	166	.5813	127.9311
120	.6756	99.1232	167	.5794	128.5105
121	.6733	99.7965	168	.5775	129.0880
122	.6712	100.4677	169	.5756	129.6636
123	.6690	101.1367	170	.5738	130.2374
124	.6668	101.8035	171	.5719	130.8093
125	.6647	102.4682	172	.5701	131.3794
126	.6625	103.1307	173	.5682	131.9476
127	.6604	103.7911	174	.5664	132.5140
128	.6582	104.4493	175	.5645	133.0785
129	.6560	105.1053	176	.5627	133.6412
130	.6539	105.7592	177	.5608	134.2020
131	.6517	106.4109	178	.5590	134.7610
132	.6496	107.0605	179	.5571	135.3181
133	.6474	107.7079	180	.5553	135.8734
134	.6454	108.3533	181	.5534	136.4268
135	.6433	108.9966	182	.5517	136.9785
136	.6412	109.6378	183	.5499	137.5284
137	.6391	110.2769	184	.5481	138.0765
138	.6370	110.9139	185	.5463	138.6228
139	.6350	111.5489	186	.5445	139.1673
140	.6308	112.1818	187	.5428	139.7101
141	.6329	112.8126	188	.5410	140.2511

Months	Sum which will increase to $1 in given number of months at 4% compounded annually	Net Leasehold Interest and amount for which policy should be written per $1 of Monthly Gross Leasehold Interest for number of months of lease unexpired	Months	Sum which will increase to $1 in given number of months at 4% compounded annually	Net Leasehold Interest and amount for which policy should be written per $1 of Monthly Gross Leasehold Interest for number of months of lease unexpired.
189	.5392	140.7903	215	.4952	154.2084
190	.5374	141.3277	216	.4936	154.7020
191	.5356	141.8633	217	.4919	155.1939
192	.5339	142.3972	218	.4904	155.6843
193	.5321	142.9293	219	.4888	156.1731
194	.5304	143.4597	220	.4872	156.6603
195	.5287	143.9884	221	.4856	157.1459
196	.5270	144.5154	222	.4840	157.6299
197	.5253	145.0407	223	.4825	158.1124
198	.5236	145.5643	224	.4809	158.5933
199	.5219	146.0862	225	.4793	159.0726
200	.5202	146.6064	226	.4777	159.5503
201	.5185	147.1249	227	.4761	160.0264
202	.5168	147.6417	228	.4746	160.5010
203	.5151	148.1568	229	.4730	160.9740
204	.5134	148.6702	230	.4715	161.4455
205	.5117	149.1819	231	.4699	161.9154
206	.5101	149.6920	232	.4684	162.3838
207	.5084	150.2004	233	.4669	162.8507
208	.5068	150.7072	234	.4654	163.3161
209	.5051	151.2123	235	.4639	163.7800
210	.5035	151.7158	236	.4624	164.2424
211	.5018	152.2176	237	.4609	164.7033
212	.5002	152.7178	238	.4594	165.1627
213	.4985	153.2163	239	.4579	165.6206
214	.4969	153.7132	240	.4564	166.0770

Case a—The lease is cancelled.

If the interest had been insured under an Eastern form the amount of insurance required for full coverage at the time the policy was taken out would have been equal to the monthly value of the lease multiplied by the number of months the lease still had to run. This would have amounted to 84 × $250, or $21,000. Since the policy was reduced automatically by $250 per month the amount of insurance in force at the time of the fire would have been $18,500. The insurer agrees to indemnify the insured for the actual loss sustained but not exceeding "the sum which placed at interest compounded annually at the rate of four per cent (4%) per annum will be

the equivalent of the interest of the insured as lessee for the unexpired term of the lease as such interest would have accrued monthly." Usually, too, the discount is waived during the first three months. Referring then to the second column of the table opposite the 74th month the present value of a monthly leasehold value of $1 is found to be $65.6430. Since the leasehold value at the time of the fire was proven to be $250 per month, the insured's recovery is limited to $16,410.75.

If the interest had been insured under a Midwestern form, the amount of insurance required for full coverage at the time the policy was taken out would have been equal to the monthly value of the lease multiplied by the value of a monthly annuity of $1 at 4 per cent interest compounded annually for a term of 84 months. Referring to the table, opposite the 84th month this is found to be $250×73.3554, or $18,338.85. This will have reduced, as previously explained,[99] to an amount equal to the present value of an annuity of $250 per month for a term of 74 months, $250×65.6430, or $16,410.75. This, too, is the amount of the loss.

Suppose that there has been, as frequently happens, an additional increase in the value of the lease before the fire occurred so that it is worth now $1300 per month, producing a leasehold value of $300 per month. The amount of the insured's loss is then $300×65.6430, or $19.692.90. Under the Eastern form the policy has been reduced to $18,500 so this amount will be paid. Under the Midwestern form the policy has been reduced to $16,410.75 and this is all that can be recovered.

Case b—The lease continues but the premises are totally untenantable for six months.

The lessee's loss is then 6×$250 or $1500. Whether insured under an Eastern form for $21,000 or a Midwestern form for $18,338.85, the insurer agrees to pay any loss up to $250 per month if the loss results from total untenantability. In either case, then, the loss is paid in full. But if the property had increased in rental value to $1300 per month the lessee's loss would be 6×$300, or $1800. Since the limit of the insurer's liability is $1500, only $1500 could be recovered.

[99] See p. 121.

Case c—The lease continues but only 60 per cent of the premises are tenantable until the end of six months required for their repair.

The lessee's loss is then 40 per cent of $250 per month for six months, a total of $600. Regardless of the form under which the risk is insured, if the insurer's liability for total untenantability is $250 per month, the limit for partial untenantability will be proportionately reduced to $100 per month which allows recovery in this case of the full loss. But if the property has increased in value so that the lessee's loss is 40 per cent of $300 per month for six months, or $720, the same limitation upon the insurer's liability allows the insured to recover only $600 since the amount of insurance is inadequate.

Leasehold Insurance Rates.

Data relating to leasehold insurance have not been segregated from the other experience of the fire insurance companies. It is doubtful, too, whether there is a sufficient volume of leasehold insurance written so that were the data segregated they would be sufficient to allow the proper promulgation of leasehold insurance rates. Consequently the rates are based upon the direct damage fire insurance rates of the property. This is subject to the same criticisms as those directed against rent insurance rates. The fire insurance rate does not measure accurately the severity of leasehold interest losses, for in leasehold insurance there is not the same preponderance of small losses. Where leases have a long term to run the greater probability of a loss not resulting in cancellation of a lease is more than offset by the greater size of the loss which will occur in those fewer cases when the lease is cancelled. For example, suppose that 9 losses out of 10 result in direct damage of less than 50 per cent of the value of properties, that these losses result in rendering a property untenantable for an average of three months, and that in only 1 case out of 10 is the damage sufficiently serious to cancel a lease. It is known that the nine smaller direct damage fire losses are greater in their aggregate amount than the one larger loss. For the same relative distribu-

tion of losses to hold true in leasehold insurance, on the basis of the foregoing assumptions, the leases cancelled by the one more serious fire could not exceed an average duration of 27 months, for the nine smaller fires cause a loss of interest averaging three months each. It is extremely doubtful whether such a favorable situation exists. Unfortunately it can not be supported by any reliable data.

In the Eastern territory, the rules of the various underwriters associations relating to leasehold insurance are exceedingly brief, generally providing only that the leasehold insurance policy shall take the same rate as that for direct damage fire insurance on the property, unless a specific rate is made for some special form of contract. But surely the hazard of a leasehold loss depends to a large extent upon the nature of the fire clause of the particular lease. A clause which allows cancellation when there has been relatively little damage done to the property is much more hazardous than one which allows cancellation only when there has been some substantial amount of damage. In the Midwestern rules, this difference in hazard is roughly approximated by allowing a reduction in rate of 10 per cent if the lessor may cancel the lease in the event of 25 per cent or more damage to the property, a reduction of 25 per cent if 50 per cent or more damage is necessary, and a reduction of 50 per cent if 75 per cent or more damage is necessary. If the fire clause specifies that the lease can be cancelled only upon the occurrence of damage requiring longer than a stipulated time for its repair no similar reductions in rate are allowed for differences in the length of time specified. In the Eastern territory, the lack of allowance in rate either penalizes the good risks or requires the insurance company to select its risks with great care, discarding those risks in which the fire clause of the lease permits its cancellation for relatively little cause. Since the Midwestern rules apply the full building rate only when less than 25 per cent damage is required to allow cancellation, the conclusion may be drawn that good leasehold risks in the East are penalized.

Leasehold insurance rates are not applied to the full amount of insurance appearing on the face of the policy at the time the

insurance is taken out, but rather to the average amount of insurance in force during the term of the policy. Since the policies reduce in amount during their term, the full amount of insurance is in force only at the beginning of the first month of the term. If a leasehold value of $100 per month under a lease with five years still to run is insured under a one-year term leasehold policy, the policy would be written for $6000 under an Eastern form, or for $5441.34 under a Midwestern form. Since the Eastern policy reduces at the rate of $100 per month, the amount of insurance in force in the last month of its term would be $4900, and the average amount of insurance in force during the year would be $5450. It is to this amount that the fire insurance rate would be applied. This, however, is not the true average amount of insurance in force for it assumes that the amount of insurance reduces only at the end of the month whereas the interest of the insured will reduce uniformly throughout the year. In other words, it assumes that $4900 of insurance remains in force throughout the whole of the last month of the policy term, but if a fire occurred and the lease were cancelled on the last day of the term of the policy the insured could recover only for forty-eight months' leasehold value and not forty-nine. The actual average amount of insurance in force would be the average between the amount of insurance in force on the first day of the policy term and that in force on the last day of its term. These amounts would be $6000 and $4800, the average being $5400 rather than $5450. In the Midwestern territory this error is obviated by including in the rules of the rating associations and in the policy forms themselves, an illustration of the method of finding the average amount of liability throughout the policy term. Applying the principles of the illustration to the case in consideration, the amount of insurance in force at the inception of the policy is found to be $5441.34, the amount in force at the end of the last month of the term is found to be $4437.02, leaving $1004.32 having expired. The average amount of liability of the insurer therefore is the original face of the policy less one-half of the amount which has expired, or $5441.24—$502.16, leaving $4,939.18, which is also the average of $5441.34 and $4437.02.

The rate charged for the form then would be applied to this amount and the premium determined.

Another deficiency of the Eastern system arises as a result of the method of writing the insurance for the full undiscounted amount of the leasehold value. No difference in rate is allowed between long term leases on which the discount would be large and short term leases on which the discount would be small. Two similar portions of the same property are leased, the one lease continuing for two years, the other for twenty years. Each lease has a leasehold value of $100 per month. The property and leases are such that whether insured under an Eastern or Midwestern form each would carry a rate of $.50 for a one-year term policy. Under an Eastern form the first risk would be written for $2400, reducing to an average for the first year of $1850, for which the premium would be $9.25. The second risk would be written for $24,000, reducing to an average for the year of $23,450, for which the premium would be $117.25. But is the risk in the second case actually almost thirteen times as great as in the first as the difference in premiums would indicate? When it is considered that the more remote a future payment may be the less its present value, it is evident that the second risk is not relatively so large. If the risks have been insured for their true values, as they would be under a Midwestern form, the first risk would be written for $2306.19, reducing to an average of $1741.53, for which the premium would be $8.71. The second risk would be written for $16,607.70, reducing to an average of $16,328.90 for which the premium would be $81.64. A comparison of these premiums would indicate that the latter risk was only 9.37 times as great as the former. Writing of a policy for the undiscounted amount of a leasehold interest, rather than for its discounted present value, and making no allowance in rate for the greater amount of discount existing on long term leases, imposes an extra burden upon the insurers of such long term leasehold interests.

Conclusions as to Leasehold Insurance.

The superiority of the Midwestern system of writing leasehold interest insurance leads to the conclusion that it should be

adopted in other sections of the country, particularly in the East. For the time being the Midwestern system of rates could be used to advantage for it recognizes to a certain extent the difference in the degree of hazard which results from certain differences in the provisions of the fire clauses of leases. Ultimately, however, it may be possible to gather a sufficient body of data so that the rates can be promulgated independently. This will be more difficult of accomplishment than in the field of rent insurance for while every property, whether leased or not, presents a subject for rent insurance, only those which are leased under a lease which has increased in value are subjects for leasehold insurance.

IV

Use and Occupancy Insurance

Use and occupancy insurance, like other forms of interruption insurance, is written by the attachment of a special form to a direct damage insurance policy. This form of insurance originated in the fire insurance field but it may be obtained against interruption losses caused by virtually any hazard against which direct damage insurance may be written. Since the same types of forms are used when other hazards are involved as are used when the hazard is fire,[1] and since the development of these forms and underwriting principles has followed almost exactly their development in the fire insurance field, the analysis may be limited to this insurance when written against the fire hazard.

Early Theories Underlying Use and Occupancy Insurance.

The first problem which confronted those who sought to provide indemnity for that intangible loss resulting from the interruption of a business by fire was to find some means by which the amount of the loss might be measured. The theory which first developed was that the amount of the interruption loss would depend directly upon the extent of the direct damage done to the property out of which the interruption loss arose.[2] Thus, if the physical damage to the property were large, the interruption loss would be considered relatively as large. The evident fallaciousness of this theory, particularly as applied to manufacturing risks, led to the development of an entirely new plan of underwriting, the seed from which our present use and occupancy insurance system has grown. This new plan of underwriting proceeded upon the theory that a uniform loss would be experienced for each day during which a business was interrupted, and that the aggregate loss would depend upon the length of the

[1] Except for power plant hazards and electric current interruptions.
[2] See Chapter I, p. 20.

interruption. That the loss will depend upon the length of time over which the business is suspended in whole or in part is evident, but that the loss will be of a uniform amount daily is true only in a decidedly limited number of cases. The fault lay not entirely in the theory itself, but in the method and in the inflexibility of its application. To appreciate fully the principles of the more comprehensive, the more flexible and, consequently, the more accurate system in use today, it is necessary to trace its development from its origin.

Development of Policy Forms.

1. *The First Per Diem Form.*

On the assumption that a suspension of business would produce a uniform daily loss, the framers of one of the earliest use and occupancy insurance policies apparently decided that all that was necessary in order to provide indemnity for such a loss was to fix upon an amount per day for which the policy should be written and then promise to pay that amount each day during which the manufacturer was entirely prevented from producing goods.[3] The difficulties involved in isolating the particular items by which the amount of the actual loss could be measured, in forecasting the value subject to loss, and in estimating the loss of a value which would have arisen in the future only if the business had not been suspended, were avoided ingeniously by making the policy a valued one. In the event that production were only partially suspended, the policy was still valued for it promised to pay that proportion of the amount promised for a total suspension "which the product prevented from being made bears to the average daily yield previous to the fire, which, . . . , is agreed to be $———— goods per day." This form could be written providing for indemnity for any desired number of days, the amount of insurance to which the rate was to be applied being the product of the agreed daily loss and the number

[3] This form has already been referred to. See Chapter I, p. 23, and footnote 29, p. 21.

of days specified. The first and principal objection[4] to this form was that it was valued. The next step in the development of the use and occupancy insurance system was to rid itself of this valued feature. In spite of the fact that better forms were made available, valued forms similar to that above were used widely until outlawed by most underwriters' associations between 1915 and 1919.

2. *Unvalued Forms.*

Since the insured had control of the property out of which the use and occupancy value arose, valued policies were equally as objectionable as they were in the underwriting of direct damage insurance on the property itself. The first attempt to avoid the fixing of a valuation of the loss in the policy consisted in modifying the provision of the preceding form so that if production were totally suspended the company would "be liable for an amount not exceeding $———— per day."[5] It must be remembered, however, that the nature of the loss had not been set forth in the earlier policy nor was it in this. The insurance merely covered "$———— on the use and occupancy of" the described property. No provision was made for any method of measuring the actual loss suffered by the insured, and in the absence of a definition of the use and occupancy value, the policy in effect was valued. This is particularly evident when the partial suspension provision of the form is considered. It provided that "if the normal production be diminished only, then shall this company be liable for that proportion of said per diem in which such production is diminished", and that "the average daily production of the twelve months immediately preceding the fire shall, . . . , be assumed to be the normal daily production." Though the policy avoided the fixing of valuations either for the amount of a loss or for the average daily production by which the extent of a partial loss was to be measured, it clearly was valued in its application to partial losses and effectively so in its application to total losses.

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[4] Other objectionable features of this form were continued in the forms which superseded it, and will be set forth when these forms are considered.

[5] C. C. Hine's *Book of Forms*, 4th Ed., 1909. Form No. 309, p. 213.

It was impossible to divorce the protection from its valued nature without describing the nature of the value which the insurance was intended to protect. Consequently the next development in policy forms was one covering loss sustained "on account of the following fixed charges, viz: Salaries, wages, royalties, taxes, insurance and interest at the lawful rate on the cash value of the plant,"[6] and another which provided that the claim should be based upon the daily average net gain for the period of 300 working days preceding the fire.[7]

3. *Development of the Coinsurance Principle in the Per Diem Forms.*

Both of the above forms retained the daily limit of liability, but instead of expressing it in the form of dollars as was done in the earlier valued policies, they specified that the insurer's liability should not exceed one three-hundredth of the sum insured for each day of total prevention of production. When the daily limit of liability was expressed in dollars, the insurance could be written for any amount whatever, a small amount of insurance only having the effect of reducing the number of days of suspension for which recovery could be had. But with the insurer's liability per day limited to 1/300th of the amount of insurance, it was necessary for the insured to carry a sufficient amount of insurance to cover the use and occupancy value for the period of a year, three hundred working days being considered a business year for a business which did not operate on Sundays and holidays. If the insured carried less insurance than a full year's use and occupancy value, the daily liability of the insurer was reduced, and, in the event of a total suspension, the insured's recovery was reduced proportionately. This, in itself, might be considered as offering sufficient incentive for the insured to carry adequate insurance since losses resulting from total suspensions of operations may be either total or partial, depending upon their duration.[8] For a loss to be total it would be necessary

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[6] *Ibid*, Form No. 311, p. 214.
[7] *Ibid.*, Form No. 307, p. 212.
[8] Use and occupancy losses may be classified just as were rent insurance losses. See Chapter 3, pp. 71–72.

for the business to be totally suspended for a period of 300 days. With reference to a particular risk, the insured may consider this quite unlikely and be disposed to carry a lesser amount of insurance. But when he considers the greater likelihood of a total suspension for a shorter period of time and realizes that his recovery for these partial losses will be reduced if he carries insufficient insurance, he is less disposed to underinsure.

Another form of partial loss, where the buiness is suspended only in part, is still more likely to occur. Provision also should be made to reduce the insured's recovery for such losses if insufficient insurance is carried. This principle was recognized in these early forms for it is found that the per diem limit of liability of the insurer was proportionately reduced for each day of the partial suspension, though the measure by which the extent of a partial suspension was to be determined was open to criticism.

4. *Modification of the Per Diem Principle.*

To meet the criticism that for many risks the amount of an interruption loss would not be uniform for each day over which the interruption extended, forms for use and occupancy insurance were devised in which the per diem principle was modified. If a business is fluctuating or seasonal in nature, its daily use and occupancy value will vary in different periods of the year. To distribute the insurance equally over each of the three hundred working days in the year, even though an amount of insurance equal to the full year's use and occupancy value were being carried, would not provide the insured with sufficient protection should an interruption occur when the business would otherwise have been operating at its peak or above the average. To allow the insured full protection in return for the carrying of full insurance, the simplest solution seemed to be to allow the daily limit of the insurer's liability to be varied for different seasons of the year. Accordingly, forms were developed on this basis.

One of the first of these forms[9] provided for a different daily

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[9] C. C. Hine's *Book of Forms*, 1915, Form No. 366, p. 247.

limit for each month in the year. Hence, if in the past year's business, a use and occupancy value of $2500 had been produced in the twenty-five working days of January, the policy would be written to cover to the extent of $2500 for the whole month of January, and not exceeding $100 per day for each working day in the month. If, on the other hand, a value of $5000 had been found to exist for the 25 working days of July, the policy would be written for $5000 on July's business, the daily liability of the insurer not exceeding $200 per day for each working day in the month. The whole policy would be written for the sum of the total monthly coverages. By this modification of the original per diem principle, coverage for fluctuating businesses was provided upon a more accurate basis.

It is to be presumed that the form permitted a variation in the per diem limit for each calendar month on the grounds that the accounts of a business were kept and could be analyzed on a monthly basis. The forms which were adopted by the underwriters' associations a short time later for the coverage of fluctuating risks[10] were made more flexible by specifying that the insurer's liability should be "at a rate not exceeding the following amounts for each working day of such prevention: For each operating day from ———— to ———— (incl.) $ ————. For each operating day from ———— to ———— (incl.) $ ————," et cetera. If an insured's books were kept on a monthly basis, the proper dates could be inserted in the form and it would be, in effect, the same as the earlier form, but if a business were found in which the earnings varied not from month to month, but from season to season and the seasons began on other than the first day of the month, the later form could take cognizance of this fact whereas the earlier could not.

When uniform forms were first promulgated, another form was set forth for the coverage of seasonal risks,[11] by which was understood those businesses which produced constant earnings while they were operating but which operated only during a

[10] *Uniform Rules of the Eastern Union*, 1915, pp. 72–75.
[11] *Ibid.*, pp. 75–77.

portion of the year. This form limited the insurer's liability to an amount "not exceeding $ ———— for each working day between ———— and ———— (inclusive) and this company is hereby relieved from all liability for suspension of operations during the remainder of the year, *i. e.*, from ———— to ————." In all other respects this form was the same as the form for use on fluctuating risks. A seasonal risk could have been covered equally as well under the fluctuating form by inserting in the first blank the dates between which the business operated and the daily limit of liability for that period, and in the second blank specifying the dates between which the business was idle and the daily limit of liability for that period as "zero" or "none." This form was superfluous and soon was dropped.[12]

5. *Forms Departing From the Per Diem Principle.*

Between 1915 and 1922 the Eastern Union had developed its rules and forms for underwriting use and occupancy insurance, but progress was slow. In 1922 it effected a sweeping revision. Out of it there emerged some additional forms which scrapped the per diem limit and substituted for it a weekly limit of liability.[13] For businesses which produced a fairly uniform amount of earnings week by week the insurer's liability was limited to an amount "not exceeding 1/52nd of the amount of this policy for each week of the suspension." For those businesses whose earnings fluctuated throughout the year or ceased during a portion of the year, the form contained a clause which provided a specific limit for each week of a stipulated period and a different limit for each week of other stipulated periods. Such forms have been developed to cover more adequately risks in which the business varied on different days of the week. If, for example, a department store produced a large volume of business on Mondays because of reduced price sales, a per diem form of use and occupancy insurance written for an amount equal to the year's use and occupancy value would not have afforded complete indemnity for a loss caused by a suspension which included a

[12] No reference to it is found in *Uniform Rules of the Eastern Union*, 1919.
[13] *Uniform Rules of the Eastern Union*, 1922, pp. 72A-73A; 76-77.

Monday. The daily limit of the policy, expressed as 1/300th of the annual use and occupancy value, would have amounted to the average daily insurable earnings, but Monday was a day of above-average earnings. So, for each Monday on which the business might have been suspended the insured would have suffered a loss in excess of the policy limit and would not have been compensated for the extra loss. If, on the other hand, the risk had been covered on a weekly limit form it would not have mattered that Monday was an above-average day, for the only limit of the policy would have been the weekly limit, and the high loss on Monday, since it was less than this limit, could have been recovered in full.

Thus far in the development of use and occupancy insurance forms, it had been presumed that the insured was gifted with sufficient prescience to predict accurately the daily or weekly variation in his insurable earnings for a year or more in advance. It was necessary for him to do so particularly if he desired coverage on a form with varying daily or weekly limits for different periods of the year. Though he might have been able to forecast correctly the total of his insurable prospective earnings, it would have been of no avail had he not been able also to anticipate their periodic variations. These variations are not easy to estimate. A difference in the week upon which Easter falls will cause a clothing merchant's earnings to vary from those of the same week of the previous year. A change in the date of a special sale in one year as compared with another, or the institution of a new selling event, makes it virtually impossible to foretell the exact variation in daily or weekly earnings which will result. To overcome these above objections to the existing forms, it was necessary to dispense with the use of periodic limits upon the insurer's liability, and to provide for payment of the loss in the proportion which the insurance carried bore to the annual use and occupancy value.

Prior to 1915 a form embodying this coinsurance principle, similar to that of direct damage insurance forms, had been used by the Home Insurance Company.[14] It was short-lived, however, for

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[14] C. C. Hine's *Book of Forms*, 1915, Form No. 367, p. 248.

in 1915 it did not appear among the forms promulgated by the Eastern Union nor in those of other underwriters' associations. Nevertheless, it is worthy of note for two reasons. First, it was the first form which departed from the plan of apportioning the coverage over definite units of time. Second, one of the most recent developments in the use and occupancy insurance system has been the adoption of forms embodying the same type of coinsurance provision. This form covered "$———— on the profits derived from the use and occupancy" of the property described. It further provided that should fire render the property unproductive "this company shall be liable for such proportion of the actual loss of net earnings occasioned thereby . . . as the amount hereby insured bears to a full twelve months' net earnings." It also defined the term "net earnings" and stipulated that their amount for the corresponding season of the twelve months immediately preceding the fire should be used as a basis for determining the amount of the loss.

This form was suited equally well for risks which provided uniform or regular earnings day by day or week by week and for businesses which fluctuated or were seasonal in nature. A straight per diem or weekly form was found unsuitable for fluctuating or seasonal risks. When the per diem limit or the weekly limit of the policy was varied according to a predetermined scale, the forms still provided incomplete protection if the insured incorrectly estimated either the amount or the time of the variation in his prospective earnings. This error he was more likely to make than to avoid. A form which provided for no periodic limit upon the liability of the insurer, which made no attempt to distribute the insurance specifically over future periods of time, but only stipulated that a "full twelve months' net earnings" be insured, avoided the possibility of error in misjudging the periodic variation in insurable earnings. Only the possibility of error in estimating the aggregate of a year's future earnings remained, but this possibility could not, and can not, be overcome by any possible modifications of the policy forms. If a risk had been covered under a form of the type described it would have made no difference how the earnings might have varied over the period covered by a loss. The in-

sured would have been entitled to full recovery if the insurance carried had been equal to the annual use and occupancy value as defined. Why this form, the best which had been developed up to the time of the general adoption of uniform forms by various underwriters' associations, was not also adopted by them, is difficult to understand.

The principle of the foregoing form was revived in 1925. At the insistence particularly of the National Retail Dry Goods Association, certain reciprocals had been writing a coinsurance form of use and occupancy insurance. In 1925 the Eastern Union amended its rules to allow the writing of similar forms[15] and other underwriters' associations soon followed its lead. These forms provided for payment of the loss in the proportion which the insurance carried bore to the stipulated percentage of the defined annual use and occupancy value. Coinsurance clauses of 100 per cent, 90 per cent and 80 per cent were permitted, while clauses of less than 80 per cent were discouraged by a prohibitive increase in rate. By the abandonment of the daily or weekly limits of liability in these forms the objections thus far advanced against the per diem and weekly forms were overcome. Since the coverage afforded under these policies was extended to protect against losses not covered by the earlier forms, a more complete discussion of them must be deferred.[16]

6. *Separation of Forms for Manufacturing and Non-Manufacturing Risks.*

Use and occupancy insurance originally was developed for the coverage of manufacturing risks. All of the earlier policies provided that the insurer should be liable for the loss resulting from the total or partial prevention of the *production* of finished goods caused by the hazard insured against. As this form of protection developed, merchants and others, whose function was to market rather than to produce goods, sought protection against loss resulting from the necessary suspension of their

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[15] *Uniform Rules and Clauses of the Eastern Union*, April, 1922 as revised June, 1925, sections 27 and 28, pp. 69A–69D; and forms, pp. 77A–77E.

[16] See pp. 168 et. seq.

operations. It was obvious that the measure of the loss could not be the decrease in the volume of production, so special forms were devised to cover non-manufacturing risks. These forms followed closely the forms used for manufacturing risks, merely omitting any reference to production as the source of the insured earnings.[17] In 1919 the forms for coverage of manufacturing and non-manufacturing risks were combined into one form applicable to either class of risk. This was accomplished by providing in the insuring clause that if the described property should be "destroyed or damaged by fire . . . so as to necessitate a total or partial suspension of *business*, this company shall be liable . . . ," and by defining the term "business" to mean: "(a) In a manufacturing property: The production of goods; (b) In a mercantile property: The sale of goods; (c) In other classes of property: The carrying on of the business operations usual to the class."[18] In a manufacturing risk, then, only the destruction of such property as would have contributed to further production would cause an interruption contemplated by the policy. This property would include the buildings and equipment making up the plant, raw stock and stock in process, but would exclude finished goods which had already been produced. So the policy stipulated that, " . . . , if covering on replacement of stock in a manufacturing property no liability is assumed on account of damage to the finished product or for the time required to reproduce any finished product which may be damaged." In a mercantile risk, on the other hand, the destruction of such property as would have contributed to future sales would cause an interruption contemplated by the policy and this would include not only the building and equipment, but also the stock of finished goods which the merchant had for sale. These goods bear the same relation to a mercantile risk as raw stock bears to a manufacturing risk. In the event of their destruction the business is unable to produce earnings until such time as they can be replaced.

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[17] Compare forms No. 307 and No. 310 in C. C. Hine's *Book of Forms* 1909, pp. 212 and 213; and compare forms 1, 3, and 5 with forms 2, 4 and 6 of the Uniform Forms in *Eastern Union Rules*, 1915, pp. 70–77.

[18] *Eastern Union Rules*, 1919, pp. 61–63.

This brings to the surface the underlying distinction made between the time at which earnings originate in manufacturing and in mercantile risks. In manufacturing risks it was assumed that earnings arose from production, not from sales, and that the earnings of a particular period bore a direct relation to the volume of production for that period. In other words, earnings were to be credited to the period in which the goods were produced, not to the period in which the earnings were realized. In a mercantile business, earnings were assumed to arise from sales and to be a credit to the period in which they were realized. Insurance under the use and occupancy policy covers prospective earnings from which would have come the manufacturer's continuing expenses and profits. When should each of these be considered as earned, when goods are produced or when goods are sold? As production proceeds, the value of the materials upon which the manufacturer works increases. This is reflected in the increased inventory valuation. If a fire occurs and destroys his finished goods or goods in process, he can recover under his direct damage fire insurance policy for these increased values. Hence, his expenses are earned as goods are produced, even though not realized until the product is sold. As soon as the value of the inventory is increased the manufacturer has taken credit for his expenses. If production ceases, even though he has finished goods on hand with which to continue sales, the manufacturer is losing the benefit of those expenses which continue, since he is not able to turn them into increased inventories. If sales are interrupted through the destruction of finished goods but production continues, the manufacturer's loss is a loss of expenses which already have been earned and for which credit has been taken. These expenses have been included in the value of the finished goods and are recoverable under the direct damage fire insurance policy.

This leaves open the question as to when profits, as distinct from expenses, are earned. It is generally considered poor accounting policy to take credit for profits until they have been realized or are definitely realizable. Profits on goods produced, but not yet sold, will not be realized until later. To credit them to the period during which the goods are produced would

mean that inventories of finished goods would be written up to selling prices less estimated expenses of delivery. A recognized authority in accounting says, this is "a practice which deserves condemnation."[19]

From an insurance viewpoint, then, is there any justification for excluding from the use and occupancy coverage of a manufacturer the right to recover profits which would have been realized during the period of the interruption from the sale of the finished goods which have been destroyed? This profit may be recovered under a profits and commissions insurance policy,[20] and, therefore, should be excluded from the use and occupancy insurance contract. In other words, with proper coverage the insured could recover such a loss, and to provide for the coverage of profits on lost sales (*i. e.*, on destroyed finished goods) under the use and occupancy insurance policy would permit double insurance and double recovery for the loss. The exclusion of such a loss forces one to the conclusion that, since profits on all goods which have been produced up to a given time are realizable under other coverage, loss of production is the factor which determines the existence, but not the amount, of the profits which a manufacturer will lose over the period during which his operations are suspended. For insurance purposes, then, his profits must be considered earned as the goods are produced. This conclusion, though contrary to good accounting practice, is further strengthened by considering that use and occupancy insurance must be written for manufacturers who produce on order as well as for those who produce for stock. If a plant is making machines which take six months to complete and payment will be made for them upon their completion, it can not be said that the profit realized was earned only on the day of its realization. Just as the expenses of the producer have been earned as production proceeded, and are represented in the increased value of the materials, so too, his equity in the profit which will later be realized is increasing.

For those businesses which produce and sell goods fairly

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[19] R. H. Montgomery, *Auditing*, Ronald Press, 1916, p. 94.
[20] See Chapter V.

constantly, it would make little difference whether the profits and continuing expenses of a given period after a fire were related to a decrease in production or to a decrease in sales. In some cases it may be desirable for sales to be set up as a basis for determining the loss. Thus, where a business has a large stock of undamaged finished goods on hand at the time of a fire which interrupts its production, it may suffer no loss. If the stock of goods is sufficient to carry on sales until production can be resumed at a rate sufficient to supply current orders, and no increased expense has been necessary, those expenses which continued during the interrupted production would have produced no benefit for the manufacturer except to add to his already large stock. In this case production would have ceased, or the rate of production would have been diminished, even had there been no fire. But if depletion in sales were set up in every case as the basis for determining the extent to which profits or continuing expenses were lost, it would necessitate a revision of the entire system of use and occupancy insurance for manufacturers.[21]

From 1919 until 1921 both manufacturing and mercantile risks were written upon the general forms suited to either class by the inclusion of provisions which applied only if the risk covered were a manufacturing risk. In 1921 forms were separated for each class but they were essentially the same as the general form of 1919, the manufacturing form including, and the non-manufacturing form excluding, the above provisions.[22] In the drastic revision of rules and forms accomplished by the Eastern Union in 1925, the forms which are in use today were adopted.[23] In these forms the definitions of the word "business" have been omitted. As a result there is now no definite statement in the policy that the manufacturer's loss shall be measured by the resulting decrease in production. In fact, no definite method of measuring the loss is stipulated in either the manufacturing or the non-manufacturing form, that method being applied which

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[21] This is the basis of English Profits Insurance. See p. 182 et. seq.

[22] *Eastern Union Rules*, 1921, Rule 68, Forms 1 and 2.

[23] Except that the coinsurance forms then adopted have been improved considerably. See discussion, pp. 168 et. seq.

the adjuster thinks most equitable, be it sales or output. The only distinctions now made between the two classes of risks lie in the nature of the property, the loss of which may result in a suspension of business, and in the different limitations upon the period of indemnity which are made necessary.[24]

Modern Forms.

The evolution of various phases of use and occupancy insurance has been traced because it explains many of the characteristics of our present system. Until 1915 this insurance was written under widely varying forms, each insurance company drawing up its own forms embodying any conditions which it thought advisable. Since that time the sectional underwriters' associations have secured almost complete uniformity. Most of the developments have originated with the Uniform Rules and Clauses Committee of the Eastern Union.[25] These developments have been embodied in its rules which serve as a model for the other sectional associations and for the organizations having immediate jurisdiction. In the large majority of cases these organizations have adopted the rules verbatim. Slight changes have been made to meet local requirements, but these changes have been of local significance only.[26]

The Eastern Underwriters' Association now publishes eight recommended standard forms of use and occupancy insurance contracts.[27] Three of these forms are intended for manufacturing risks and five for non-manufacturing or mercantile risks. The forms for manufacturing risks are (1) the straight per diem form for risks where earnings are constant and continuous throughout the policy year, (2) the fluctuating per diem form for risks where earnings fluctuate during different periods of the

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[24] See pp. 156–158.

[25] Now the Eastern Underwriters' Association.

[26] For example, specific rules for determining rates for coal mining properties are found in the rules of rating organizations of several soft coal mining states. In Minnesota, however, the rules differ materially from those of the rest of the country because of anti-coinsurance legislation which has been construed as prohibiting the use of periodic limits. See note 45, p. 85.

[27] *Eastern Underwriters' Association Rules*, Appendix. Either the forms or the clauses of the forms have been made mandatory by most of the local associations.

year or continue only during a portion of the year, and (3) the coinsurance form for any type of risk whether earnings are steady, fluctuating or seasonal. The forms for mercantile risks include three forms similar to those for manufacturing risks and also include, (1) a weekly form for risks where earnings are constant week by week but not day by day, and (2) a weekly form for risks where earnings fluctuate or are discontinued during some weeks of the year. In some jurisdictions provision is made for the coverage of mercantile risks on additional forms containing only monthly limits upon the insurer's liability,[28] these forms being the same as the weekly forms except for the difference in limits.

Forms containing weekly and monthly limits of liability have not been provided for manufacturing risks in any territory. The reason for this is found in the fact that while a merchant's sales, and therefore his earnings, may vary regularly on different days of each week or in different weeks of each month, there is no reason for expecting similar variations in a manufacturer's production or earnings. The production and earnings of a manufacturer frequently will vary in different seasons of the year, but during the season there will be no uniformly greater production or earnings on each Monday, for example, than on other days of the week, nor in each first week of the month than in other weeks. Sales of retail stores or jobbers, on the other hand, show not only seasonal variations but also daily or weekly variations within the seasons. The fluctuating per diem forms with varying per diem limits can care for the case where earnings are regular within a season but varying as between seasons. The weekly or monthly limit forms, designed to care for variations of earnings within a season, therefore, are unnecessary for manufacturing risks.

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[28] See *Rules of the Board of Fire Underwriters of the Pacific*, pp. 17U and 17Y. In August, 1929 the Rating Bureaus in the Midwestern territory abandoned both the weekly and monthly limit forms, since the coinsurance form had been designed to cover better the same situations as those for which the weekly and monthly limit forms had been devised. The Chicago Board of Underwriters, however, retained the monthly form.

Uniform Provisions of the Different Forms.

1. *Description of the Property.*

Regardless of the type of policy form by which a risk may be covered, it is necessary that the property whose damage or destruction may cause the loss be adequately described. It is upon the fire hazard of this property, considered in the aggregate, that the rate for the insurance will be based. If a business requires for its operation several different buildings each building should be included specifically in the property described. Should one be omitted the interruption loss which might follow its destruction would not be covered by the insurance. The policy further provides that if the machinery or equipment contained within the described buildings be destroyed or damaged so as to necessitate a suspension of business, the company shall be liable. The reason for this is that it would be equally as disastrous for a merchant or manufacturer if his business were interrupted by fire damage to elevator machinery as it would be were the building itself damaged.

It has been seen that there may be a difference in the property covered under a manufacturing form and that covered under a non-manufacturing form. By the payment of an extra premium, either the manufacturer or merchant may have protection for interruptions resulting from the damage to or destruction of stock. If such coverage is not included in the contract, the policies contain a clause by which the insurer specifically disclaims liability for interruption losses for the period of time required to replace the stock. If such coverage is desired and the risk is a mercantile risk, the term "stock", without qualification, is inserted in the clause describing the property. If the risk is a manufacturing risk the term "raw stock" is inserted and it is defined to mean "materials and supplies usual to the insured's business in the state in which the insured receives them," thus excluding stock in process and finished goods. As has been explained before, the insurer also specifically avoids liability for any loss resulting from damage to or destruction of finished stock.

2. *The Period of Indemnity.*

From the time of the origin of use and occupancy insurance, the period over which the insured may be entitled to indemnity has been defined essentially as the time, commencing with the date of the fire and not limited by the date of expiration of the policy, which would be necessary, with due diligence, to rebuild, repair, or replace such part of the described property as was damaged or destroyed.[29] This period is the same, in effect, as that described for rent insurance. When the described property is rendered available for use to the extent to which it was being used before the fire occurred, the loss is considered to have ceased. But an interruption resulting from an insured hazard might produce a further loss by continuing over an even longer period. A merchant may find that he has lost customers during the period over which his shop has been necessarily closed and that he can not, therefore, bring his sales up to their normal level for some time after the property has been put into condition. He will suffer a loss of earnings and the loss will be an interruption loss, for his business is still interrupted as a result of the fire. This condition could be cared for in the policy by defining the period of indemnity for mercantile risks as the time from the date of the fire until the sales of the insured could, with diligence and dispatch, be brought up to the level at which they would have been had there been no fire. Such a stipulation would require that the policy specifically provide for the use of the merchant's past sales as a standard by which the results of the business after the fire might be measured, and to which the insurable value and the amount of the loss would be definitely related.[30] It would also be necessary to place some maximum limit of time beyond which the effects of a fire no longer would be considered to exist. Otherwise an insured might claim that his below-normal sales for an unreasonable period of time in the future were the result of the fire which he had experienced.

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[29] Compare Form No. 146, p. 63 in C. C. Hine's *Book of Forms*, 1882, with the modern forms.

[30] How this is accomplished under the English Profits Insurance system may be seen by reference to p. 182-183.

In manufacturing risks the effects of a fire may be felt for some time after the plant has been rehabilitated. Though the physical equipment may allow the proprietor to produce a normal quantity of goods, the cancellation of orders as a result of his inability to fulfill them after the fire, may make it highly impractical for full production to be resumed. The only difference between the mercantile and the manufacturing risk is that the merchant *can not* bring his sales up to normal whereas the manufacturer *can* but *does not consider it advisable* to resume normal production. The period of indemnity could not be defined, then, as the time until production could be brought up to normal, but might be considered as the time until, with due diligence, production ought to be resumed at a normal rate, but not exceeding a stipulated period after the fire.

To reduce as far as practicable the length of the period of indemnity, all forms require that in the event of a loss any surplus or reserve machinery, equipment, or stock (as defined in the form) "which may be owned, controlled or used by the insured shall be used in placing the property in condition for continuing or resuming operations." This the insured ordinarily would do in his own interest. The clause works no hardship upon him but prevents an unscrupulous insured from recovering during a period over which there should be no loss.

It is also provided that "as soon as practicable after any loss, the insured shall resume complete or partial operation of the property herein described and shall make use of other property, if obtainable, if by so doing the amount of loss hereunder will be reduced, and in the event of the loss being so reduced such reduction shall be taken into account in arriving at the amount of the loss hereunder." This clause is intended to reduce the period of indemnity to a minimum by requiring resumption of operations as soon as possible, but it is more especially intended to reduce the amount of the loss which may be claimed during the period of indemnity.[31] If an insured is able to obtain temporary quarters and, without additional expense, resume

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[31] The operation of the clause in this respect will be considered later. See pp. 175–176.

normal operations sooner than the original property could have been repaired, the period of indemnity will be correspondingly reduced. But if operations could be resumed only at an increased expense, the period of indemnity will be limited only by the time required to restore the original property.

Another proper restriction upon the length of time over which the insured is entitled to indemnity is found in a clause by which the insurer is relieved from liability "on account of loss which may be occasioned by any ordinance or law regulating construction or repair of buildings, or by the suspension, lapse, or cancellation of any license or lease, or for any other remote loss." The purpose of this clause is obvious. If the insurer were to be responsible for a loss until a property could be rebuilt and its rebuilding were prohibited by law, the insurer's liability would continue indefinitely. Furthermore the loss is not caused directly by the hazard insured against, but by the adverse legislation. Where a lease is subject to suspension or cancellation the loss is not properly a use and occupancy loss, but is a leasehold loss and should be insured under such a form.[32]

Originally the use and occupancy policy was intended to cover only interruption losses resulting from the destruction of or damage to buildings, machinery and equipment. When the coverage of the policy was extended to cover interruptions due to the destruction of stock[33] the question arose as to the effect which this would have upon the period of indemnity. For the mercantile risk it was evident that business could not be resumed until stock was replaced upon the merchant's shelves. If his building were so damaged that ninety days would be required to repair it, and if his damaged stock could be ordered and received within thirty days, after which ten days would be required to price and place it in position within the store, the period of indemnity would be extended for only ten days beyond the period covered had stock replacement not been included.

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[32] Thus where a lease had 164 days to run and was cancelled the insured's recovery was limited to the 84 days which were necessary to repair the damage done. Grand Pacific Hotel Co. v. Michigan Commercial Insurance Company (Illinois Supreme Court) 90 Northeastern Reporter 244.

[33] Approximately since 1915.

Diligence would require that the stock be ordered in time so that it would be received before repairs to the building had been completed, thus limiting the period of indemnity to one hundred days, ninety days for repairs and ten days to prepare the stock for sale. If only stock had been damaged the period of indemnity would include the time required for its replacement and preparation.

For manufacturing risks the question of stock replacement presented different problems. The manufacturer had, broadly, two classes of stock—materials to be worked upon and materials already worked upon. So long as there were materials to be worked upon the business of production would not be suspended. Hence, only the destruction of "raw stock" could cause a suspension and the policy could be extended to cover the period required for the replacement of such "raw stock" only. This period of indemnity was also restricted by providing that "liability shall be limited to the period of time for which the damaged or destroyed raw stock would have made operations possible." This stipulation is reasonable for if the manufacturer had only sufficient raw stock to continue operations for ten days and a new supply could not be procured for sixty days, it would have been necessary to suspend operations for fifty days even though no fire had occurred.

It was feared that an insured might claim the right to include as part of the period of indemnity the time required to reproduce the finished stock which had been destroyed. To avoid this possibility not only liability for loss resulting from damage to finished goods but also liability for loss "for the time required to reproduce any finished stock which may be damaged or destroyed" was specifically denied in the policy.

In 1925 an additional clause was added by which, if liability for suspension of business due to the damage to raw stock had been assumed, the period of indemnity was extended to "include such additional time, if any, not exceeding thirty business days,[34] as may be required with the exercise of due diligence and dispatch to replace any stock in process damaged or destroyed

[34] This limit may be extended by endorsement on the policy and the payment of an extra premium.

and/or to restore the same to the state of manufacture at which it stood at the time of the fire." Stock in process was defined to mean "raw stock which has undergone any aging, seasoning, mechanical or other process of manufacture at the above location but which has not become finished stock." Such a provision may be shown to be inconsistent with that by which the time required for the reproduction of finished goods is excluded from the period of indemnity. One or the other is incorrect in underwriting principle. The reason for the exclusion of finished goods' replacement has been explained.[35] The direct damage fire insurance policy has allowed recovery for the expenses incurred in their production, and the profits and commissions insurance policy has covered the profits which would have been realized. When production is resumed the expenses involved will be reflected in the value of the products made and will be realized upon their sale. To allow recovery for them under the use and occupancy policy by extending the period of indemnity to include the time necessary to reproduce the destroyed finished goods would allow the insured to profit because of the fire. The same reasoning holds true for goods in process except that the proportionate part of the profit accrued to the date of the fire, which would have been realized upon their completion and sale, is not covered by profits and commissions insurance. The expenses attributable to the goods in process, in their condition at the time of the fire, have increased their value and the amount of indemnity received from the fire insurance on them reimburses the insured for these expenses. In other words, the insured is in the same position at the time when operations may be resumed[36] as he was at the time of the fire. After production is resumed the expenses incurred to produce goods in process in the same state of manufacture as those which were destroyed will be received by the insured upon the sale of the goods when finished. Consequently there is no need for the period of indemnity to be extended so that such expenses may be recovered also under the use and occupancy insurance policy. To do so

[35] See p. 149.

[36] Except for his proportionate profit on the goods in process which have been destroyed.

allows double recovery for expenses whereas only the proportionate profits on the destroyed goods in process have been lost. This loss of profits should be coverable under a profits insurance policy and not under the use and occupancy form.

The maximum period of indemnity under the different forms of policies is intended to be one year, unless provision is made otherwise for risks requiring more than a year for their replacement. There is no clause in any of the forms by which this is definitely accomplished. If a fire resulted in the total suspension of operations for a year the policy would be exhausted and the liability of the insurer would then cease. If the fire necessitated only a partial suspension the amount of insurance would not be exhausted by the end of the year, and an insured's claim for recovery till such time as the insurance was exhausted or the suspension terminated would be sustained, thus defeating the purpose of the coinsurance provisions of the forms. These provisions merely limit the amount which could be recovered per unit of time but do not limit the length of time over which the claim for a loss might extend. Since the rate for any form and the amount of insurance required are based upon coverage for an interruption not exceeding one year in duration, this should be incorporated specifically into each form. The clause could be worded as follows: In no case shall this company be liable for loss for a longer period than twelve months immediately following the date of the fire.

When it is estimated in advance that the period of indemnity may exceed one year, the policies are written so that an amount of insurance equal to the use and occupancy value for the estimated time required for the replacement of the property is required. If the period should be estimated as one year and six months, the straight per diem form would be written for one and one-half times the annual use and occupancy value and the per diem limit would be expressed as 1/450th of the amount of the insurance instead of 1/300th.[37] Only by carrying such an amount of insurance could the insured recover full indemnity for both total or partial losses over the whole period covered by the loss.

[37] Or 1/548th instead of 1/365th if the business operated every day including Sundays and holidays.

3. *Other Uniform Provisions.*

All contracts provide that the fire causing the damage to the property described must occur within the term of the policy. This bears no relation to the period of indemnity save to mark the date of its inception. Thus a policy may be written for a term of three years but the amount of insurance and the amount of recovery as a result of any one fire is limited to the annual use and occupancy value. On the other hand, a policy may be written for a term of one year but for an amount sufficient to cover an interruption lasting for a longer period of time. The term for which use and occupancy insurance may be written on a given risk is governed by the same rules which determine the term for which fire insurance may be written upon the property involved.

Policies also specify that the insurer's liability "shall not exceed the amount of insurance by this policy, nor a greater proportion of any loss than the insurance hereunder shall bear to all insurance, whether valid or not, and whether collectible or not, covering in any manner the loss insured against by this policy." Limiting the amount recoverable to the amount of the policy requires reinstatement of the policy after any loss. Thus if an insured suffered a total interruption loss for nine months and, before the policy expired, another fire occurred which caused an interruption for a full year, the insured could recover for only a part of this later loss unless the policy had been reinstated to its original amount. The latter portion of the above clause is to provide for contribution with other insurers, not only with those covering on other use and occupancy insurance policies, but also with those "covering in any manner the loss insured against by this policy." This will prevent an insured who has covered the rental value of his property and its use and occupancy value under separate policies from claiming a full loss of rent under both forms.

Forms also contain an appraisal clause of the same kind as that used in the rent insurance forms. It is equally as unnecessary as in those forms because the appraisal clause of the fire policy to which the use and occupancy insurance form is

attached will be applicable. Where the hazard insured against is fire, a clause is usually attached by which liability for loss caused by lightning is assumed and that caused by electrical injury to electrical equipment, whether from artificial or natural causes, is excepted. Other clauses also may be used to permit the use of equipment, operation at unusual hours, alterations and repairs, etc., which are excluded in the standard fire policy form.

The Per Diem Forms.

In all of the forms which stipulate a periodic limit upon the insurer's liability, the insurance is written to cover "the actual loss sustained consisting of: I. Net profits on the business which is thereby prevented; II. Such fixed charges and expenses as must necessarily continue, to the extent only that such fixed charges and expenses would have been earned had no fire occurred; and III. Such expenses as are necessarily incurred for the purpose of reducing the loss under the policy;" for the period of the interruption. By this the constituent parts of the use and occupancy value are determined as previously described.[38] Under it, too, the amount of the loss will be determined.

If the insurer's liability for the actual loss sustained is limited to a stated amount, or to a stated proportion of the amount of insurance, for each business day over which the suspension continues, the form is known as a per diem form. All per diem forms contain a definition of the word "day", stating that however modified it "shall be held to cover a period of twenty-four hours." The purpose of this definition is to prevent an insured from claiming that since he was operating twenty-four hours each day at the time of the fire, instead of his usual eight hours, his loss for each twenty-four-hour period after the fire would be the equivalent of that for three business days and thus entitle him to recovery to that extent.

1. *The Straight Per Diem Forms.*

If the per diem limit upon the insurer's liability is constant the form is known as a straight per diem form. The clauses

[38] Chapter 2, pp. 52–61.

by which the insurers' daily liability is limited provide as follows:

"(2) TOTAL SUSPENSION CLAUSE: The per diem liability under this policy during the time of total suspension of business shall be limited to the 'Actual Loss Sustained', not exceeding 1/300 of the amount of this policy for each business day of such suspension, except that in the case of business being operated on Sundays and/or holidays, in which event the said per diem liability shall not exceed 1/365 of the amount of this policy for each business day of such suspension, due consideration in either case being given to the experience of the business before the fire and the probable experience thereafter."

(3) PARTIAL SUSPENSION CLAUSE: The per diem liability under this policy during the time of a partial suspension of business shall be limited to the 'Actual Loss Sustained', not exceeding that proportion of the per diem liability that would have been incurred by a total suspension of business which the actual per diem loss sustained, during the time of such partial suspension, bears to the per diem loss which would have been sustained by a total suspension of business, for the same time, . . . due consideration being given to the experience of the business before the fire and the probable experience thereafter."

These clauses, considered together, effectively incorporate a 100 per cent coinsurance requirement based on the annual use and occupancy value. Exactly how this is accomplished may be seen by means of an illustration. Without regard to the particular items which make up the use and occupancy loss, let us assume that a business would suffer a loss of $1000 per day or of $300,000 for the year were it shut down completely. The proprietor secures a use and occupancy insurance policy for $150,000. In the event of a total suspension of operations regardless of how long the suspension continues, the insured's loss of $1,000 per day is recoverable only at the rate of $500 per day, for the insurer's per diem liability is limited to 1/300 of $150,000. When the suspension continues for less than a year the loss is a type of partial loss and the per diem limit of the total suspension clause applies the coinsurance principle to it. The insured is carrying but 50 per cent insurance and receives only 50 per cent of his loss. He is, therefore, a coinsurer in any case in which the loss is total for the time over which the suspension lasts. This same condition should hold true when

the partial loss results from a suspension which is only partial. Suppose that fire causes the insured to curtail his operations so that only $750 per day is earned toward the profit and expenses which would have amounted to the $1,000 per day had there been no fire. The insured's recovery then is limited under the partial suspension clause to that proportion of the per diem liability that would have been incurred by a total suspension of business ($500) which the actual per diem loss sustained ($250) bears to the per diem loss which would have been sustained by a total suspension of business ($1000), *i. e.*, to 250/1000 of $500 or $125 per day. Since the insured loses $250 per day and recovers only $125 per day of the partial suspension, he is a coinsurer to the extent of 50 per cent, the extent by which his insurance falls short of the annual use and occupancy value. In direct damage insurance policies the coinsurance clause provides for the payment of that proportion of the loss which the amount of insurance bears to the actual cash value of the property at the time of the fire. For a direct damage loss on the basis of the preceding figures the insurer would be liable for 500/1000 of $250, or $125. While the coinsurance provision of the partial suspension clause produces the same result as that of a direct damage insurance policy, it would be easier for an insured to understand were it to provide for the same procedure as that followed under the more familiar forms of insurance. This would be the case if the clause read that the per diem liability under this policy during the time of a partial suspension of business shall be limited to the actual loss sustained and shall not exceed that proportion of the actual loss sustained which 1/300 of the amount of this policy bears to the per diem loss which the insured would have sustained by a total suspension of business for the same time. . . .

By virtue of the foregoing provisions the amount of insurance required for complete protection is 100 per cent of the annual value of all of the items which might be contained in a loss.[39] In all of the different use and occupancy insurance policies the

[39] It will always be equal to at least the annual use and occupancy value, for the per diem limit of liability may never be stated as more than 1/300th of the amount of insurance.

annual use and occupancy value is the basis for the amount of insurance required.[40] This is subject to the same criticisms as were directed against the rent insurance forms using the annual rental value of property for the same purpose.[41] Unless proper provision is made in the rates for risks requiring different periods for their reinstatement, the same possibility of inequity exists as in rent insurance. But to require an amount of insurance equal to the use and occupancy value for the estimated period required for replacing the described property of a business would be impractical for several reasons. The earnings of a business are frequently subject to considerable fluctuation and if it were estimated that six months would be required to replace a risk, the earnings for which six months should be taken as a basis? To keep all forms on the same basis, whether covering fluctuating or non-fluctuating risks, the annual value basis is desirable. Further, most businesses make it a practice to prepare annual statements carefully constructed and often certified to by an auditor. Monthly, or even semi-annual, audits are used much less frequently. Though statements may be prepared more frequently than annually these statements are usually more subject to error since inventories will not be so carefully checked and values will not be so carefully determined as will those for the annual statements. More frequently than not, the only absolutely reliable statements upon which the insurer can determine the value of the items making up the use and occupancy value and also the loss sustained after a fire, will be the annual statements of the business. Consequently the only practical adjustment which can be made between different risks is an adjustment of the use and occupancy insurance rate for different periods of time required for the rehabilitation of the risks. But, as will be seen later,[42] this is not usually done and never to the degree to which it should be done.

As between risks which will require a year for their reinstatement and those which will require longer than a year, equity is secured by increasing the amount of insurance required on the latter to an amount equal to the use and occupancy value for such

[40] Except when it would take longer than 1 year to replace the property.
[41] See Chapter 3, pp. 83-84 and 106-107.
[42] See pp. 186 et seq.

longer period. This is done by the substitution of the proper fractions in place of 1/300 and 1/365 as they appear in the usual form. If the business could not be resumed after its total destruction in less than fifteen months, the fractions would be 1/375 or 1/456; in less than eighteen months, 1/450 or 1/548; or in less than two years, 1/600 or 1/730.

All forms containing per diem limits upon the insurer's liability contain a provision that, "In the event of the insurance hereunder being reduced by payment of loss, such reduction shall apply only to the amount of the policy, the daily limit of liability being unaffected thereby." In the absence of such a clause a business which had been carrying sufficient insurance and which had collected one-half of the policy as the result of a previous loss, would be unable to recover more than half of another loss even though it were of short duration. This would be manifestly unfair since the business was carrying sufficient insurance to have in the aggregate indemnity for a full year's interruption. The clause, however, does not relieve the insured of the necessity for reinstating the policy to its original amount. If it were not reinstated and the second fire caused a total suspension of business for longer than six months, the insured could not recover for the loss beyond six months. By the end of that time the amount of insurance remaining after the first fire would have been exhausted.

2. *The Fluctuating Per Diem Forms.*

Where the earnings of a business vary in different periods of the year the straight per diem form has been found to be unsatisfactory. One prominent insurance authority has stated that, "In my experience I have seen only one risk which could be fairly and adequately insured under a 1/300th form."[43] It is the usual case for a business to produce varying daily earnings over a period of time. The forms which provide for this condition by varying the per diem limit upon the insurer's liability for different portions of the year are known as fluctuating per

[43] L. E. Falls, Special Agent and Assistant Secretary of The American Insurance Company of Newark, N. J. In *Convention Yearbook*, 1926, p. 239, and in *Standard*, March 13, 1926.

diem forms. Instead of taking the daily average of the insurable earnings for the whole year, the daily averages for different portions of the year are taken to determine the amount of insurance required and to fix the maximum liability of the insurer. The only modification of the straight per diem form which this requires is a change in the total suspension clause and the addition of what is called a pro rata clause.

The total suspension clause provides for the limitation of the per diem liability under the policy during a total suspension of business "to the actual loss sustained not exceeding the amounts designated for each day of the respective periods defined in the following table, and during no other time, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

For each business day

(Month-Day) (Month-Day)

from.....to the following.....(incl.) $.....

" ..... " " " ..... " .....

" ..... " " " ..... " ....."

The pro rata clause provides that "The amount for which this policy is issued applies pro rata to each of the (foregoing) per diem amounts in the proportion that the amount of this policy bears to the aggregate of said per diem amounts multiplied by the respective number of days during which each applies." The purpose of this provision is to require the insured to carry an amount of insurance equal to the annual use and occupancy value. It is made necessary by the fact that the limit is expressed as an amount and not as a fraction of the total amount of insurance. The face of the policy must correspond to the sum of the products of the per diem limits and the number of days over which each limit applies. If a lesser amount of insurance is carried the clause effects a proportionate reduction in each of the limits specified. Hence, if only fifty per cent of the annual use and occupancy value is insured the per diem limits for each period, if properly estimated, will amount to only fifty per cent of the insured's actual loss.

There is no need for the partial suspension clause of the

fluctuating per diem forms to be any different from that of the straight per diem forms. The liability of the insurer in case of a partial suspension should be, and is, limited to the same proportion of the per diem liability which would have been sustained by a total suspension of business for the same time.

Weekly and Monthly Limit Forms.

The weekly and monthly limit forms for use and occupancy insurance, for the reasons seen before,[44] have been needed only for mercantile or non-manufacturing risks. Again two types of forms are used (1) those in which the weekly or monthly limit is constant, and (2) those in which the limit is varied for different portions of the year. There is no need for a detailed discussion of these forms for they will operate in exactly the same fashion for each week or month as did the per diem forms when the basic unit of time was the day. In weekly forms the word "week" is substituted in each place in which the word "day" is found in the per diem forms, and in the straight weekly forms the weekly limit of liability will be expressed as 1/52 of the amount of insurance, in place of the limit of 1/300 per day. In monthly forms the same sort of correction would be made.

Defects of Periodic Limit Forms.

Any form of contract which provides for a periodic limit upon the insurer's liability, whether it be constant or fluctuating, is subject to the criticism that, no matter what the degree of care exercised, the insurance may be improperly distributed over the period of the loss. Though one might have an amount of insurance equal to the full annual use and occupancy value of his business, if the distribution of the amount of his loss in point of time did not coincide with the limit or limits fixed by the form for the period of the loss, he would not be allowed full recovery under the policy. Suppose the limits of a policy for the 25 operating days of July amount to $400 and for the 25 operating days of August amount to $600. As the result of a fire the insured is out of business during July and August. He can prove

[44] See p. 152.

a loss of $500 per day for the whole period. In other words his business would not have fluctuated as he had anticipated when he took out the insurance. Since the policy limit for July was $400 per day he can recover only that amount even though he can prove a per diem loss of $500. On the other hand he can prove a loss of only $500 daily during August and, though the policy limit is now $600, he can recover only his actual loss. He has not been indemnified for his full loss in July though, in the aggregate, he has been carrying sufficient insurance.

Another major criticism which may be advanced against all forms providing for periodic limits of liability is that every item for which claim may be made must be insured to its full annual amount, in spite of the fact that some of them would not be lost over an interruption lasting a whole year. In short interruptions certain expenses of the insured, particularly his payroll, cannot be avoided, for it would not be advisable for him to break up his organization if business could be resumed at an early date. In a long interruption such expenses would not continue. On the other hand, expenses such as interest on the indebtedness of the business would continue whether the interruption were of long or short duration. To recover for either item the policy requires that it be insured for its annual amount, and whether it is a $100,000 payroll or $100,000 of interest on indebtedness, the premium which the insured must pay is increased as much by one as by the other. Consequently such items as payroll were not insured. As a result of this, one insured who suffered a large use and occupancy loss of relatively short duration, found that he had been coinsurer to the extent of over 40 per cent, whereas had the loss been total he would have been coinsurer to the extent of 16-2/3 per cent only.[45]

The Coinsurance Forms.

To overcome these objections to the then-existing forms, the Eastern Union in 1925 adopted forms which, in lieu of periodic limits of liability, contained coinsurance clauses of the same kind as those which were used in connection with direct damage

[45] Report of Edgar C. Fisher, Financial Secretary of The Shepard Company, Providence, R. I. on The Shepard Company Fire of March, 1923.

insurance lines. Two forms were provided, one for manufacturing risks, the other for mercantile or non-manufacturing risks. The clauses provided that, "in the event of loss, this Company shall be liable for no greater proportion thereof than the amount hereby insured bears to ———— per cent (.... per cent) of the sum of the net profits and all charges and expenses which would normally have been earned (had no fire occurred) during the period of 12 months immediately following the fire." This latter sum was defined as the annual use and occupancy value. The loss was defined to consist of the net profits on the business prevented, fixed charges and expenses which must necessarily continue to the extent that they would have been earned, and additional expenses incurred for the purpose of reducing the loss.[46]

By the elimination of periodic limits of liability the insured was not required to forecast the probable variation in his earnings over an indefinite future time, *i. e.*, one year from the date of the fire. He was required to forecast only their probable aggregate amount. The probability of error and its serious consequences was greatly reduced. This objection to the existing forms was overcome. But the forms were equally as onerous as the existing forms when the possibility of recovering for those expenses which continued only if the interruption were of short duration is considered. In spite of the fact that rates for these forms were made materially higher (in fact, prohibitively higher) the insured was still required to insure the full annual amount[47] of such items as payroll in order to recover them in the event of a short suspension of business. In fact, *all* charges and expenses which would have been earned were required to be insured for their annual amounts, regardless of their possibility or probability of continuance. When, instead of a 100 per cent clause, an 80 per cent coinsurance clause was used, the insured was required to insure all items to the extent of 80 per cent of their annual amount regardless of the maximum length of a suspension over which they would have continued. Generally insurance

[46] Except for unimportant differences in wording this is the same as the clause quoted on p. 161, contained in all of the other forms.

[47] Assuming that the clause called for *100 per cent* insurance.

to this amount would provide an insured with complete protection since, in a long suspension of business, probably more than 20 per cent of his insured expenses could be discontinued, and in a short suspension he would be entitled to recover all of them. But still the amount of insurance required was high and the rate for an 80 per cent coinsurance clause was higher than that for a 100 per cent clause, though not proportionately.

In June, 1929, new coinsurance forms were promulgated by the Eastern Underwriters Association with a view to correcting the defect of the preceding forms. These forms provide coverage for the actual interruption loss sustained on:

"Item I. $.....on (a) the net profit which is thereby prevented from being earned and

(b) such charges and other expenses, including salaries of officers, executives, department managers, employees under contract and other important employees, as must necessarily continue during a total or partial suspension of business, to the extent only that such charges and expenses would have been earned had no fire occurred.

This Item I covers expense of necessary heat, light or power the cost of which is prevented from being earned during the time of total or partial suspension of business caused by fire.

This Item I *does not cover* any portion of the insured's ordinary payroll described in Item II.

Item II. $.....on the insured's entire ordinary payroll for a period of time not in excess of 90 consecutive days immediately following loss or damage by fire, which may continue during a total or a partial suspension of business, covering only to the extent necessary to resume the normal business of the insured with the same quality of service which existed immediately preceding the fire, and which would have been earned had no fire occurred.

This Item II *does not cover* any portion of salaries described in Item I."

Coverage is also granted, without increasing the amount of insurance, for those expenses which are necessarily incurred for

the purpose of reducing any loss under the policy, but not exceeding the amount by which the loss is reduced. Insurance may be written covering only on Item I, in which case the word "nothing" is inserted in the space where the amount of coverage under Item II would be entered. This would be desired by a business whose employees operate on a piece work or hourly wage payment plan, since the payroll would be completely discontinued even in a suspension of business of short duration. Where the continuing payroll is insured, the insured's recovery is limited to its amount for ninety days on the reasonable assumption that the payroll would not continue if the business were suspended for a period exceeding ninety days. Recovery for this loss is also limited to the extent of payments made only to such employees as are *necessary* to resume the normal business of the insured. Whether payments to employees of the insured who are employed in aiding with the repair of the property, or with the reconditioning of the stock, would be excluded is dubious. Such a loss should not be paid since the insured has already received from his direct damage policies the loss on the physical property and this includes the labor cost of its repair.

The coinsurance clause of the form provides that the insurer shall be liable for no greater proportion of any loss, including expenses incurred to reduce the loss, "than the amount hereby covered under each respective Item bears to,

(1) Under Item I, 100%[48] of the sum of the annual net profits and the annual charges and other expenses . . . described as covered by Item I, that would have been earned (had no fire occurred) during the twelve (12) months immediately following loss or damage by fire, whether or not said charges and other expenses necessarily continue during a total or a partial suspension of business.

(2) Under Item II, 100% of the insured's entire ordinary payroll, excluding only salaries described in Item I, which would have been earned (had no fire occurred) during the ninety (90) consecutive days immediately following loss or damage by fire."

By the separation of the coverage into two parts on the basis of

[48] No other percentage may be used.

the probable continuance of the different expense items, and by the application of the 100 per cent coinsurance provision to the annual value of all other continuing expenses but only to the 90 day value of the payroll, the objection to the previous co-insurance forms is removed. Under these forms the insured is allowed to recover that major expense item, payroll, which continues only if the interruption is short, and the amount of insurance required is not unreasonable. In support of the latter part of this statement there has been embodied into the rules of the Eastern Underwriters Association an account of the usual operation of the 100 per cent coinsurance provisions of the forms.[49] This account is based upon a study of the statistics of some 3000 stores gathered by the Harvard Bureau of Business Research. It was found that on the average the annual payroll of a business amounted to 40 per cent of the annual gross profit, and the net profit and all other expenses to 60 per cent of the annual gross profits. Insurance upon the payroll is required only in the amount to which it would have come for the ninety days after a fire. To be safe, the insured should carry an amount of insurance on this item equal to that of the 90 consecutive days on which it would have been highest. This would probably be slightly over one-quarter of its annual amount. The required insurance on this item is usually, then, slightly over ten per cent of the annual gross profits. This, added to the 60 per cent of the annual gross profits required to be insured in full, gives somewhat over 70 per cent of the annual gross profits as the amount of insurance usually required by the 100 per cent coinsurance clause as it is applied in the forms.

Loss Adjustments—Procedure.

In the adjustment of any use and occupancy loss the adjuster first will satisfy himself that a fire has occurred, that the property was occupied and used by the named insured, and that the normal business of the insured will be interrupted or that it can be maintained only at an increased cost. If it is found that the

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[49] Page 67 of the rules as amended, June 12, 1929.

business can be carried on at another available location or that surplus machinery, stock, and the like, can be used by the insured, as required by the policies, the adjuster is duty-bound to aid the insured in suggesting these ways and means of reducing the loss.[50]

It is the customary practice to adjust and pay the use and occupancy loss before the entire loss has been suffered, that is, before the period over which the business is interrupted has terminated. In those cases in which the claim made by the insured seems unreasonable, the adjustment may be postponed until the interruption has ceased and the actual conditions operating over the period determined.[51] In the usual case, however, the settlement will be based upon estimates made of the amount of the loss under the probable operating conditions which will prevail during the estimated period over which the business will be interrupted. As can be seen, so much depends upon estimates that more is required of an adjuster in bringing the settlement of a use and occupancy loss to a satisfactory conclusion than is required in any other line of insurance. This is especially true in view of the fact that the different forms offer no guide for deducing the loss sustained except that due consideration shall be given to the experience of the business before the fire and to the probable experience thereafter.

To determine the amount of the loss the probable earnings of the business had there been no fire must be forecast.[52] This estimate will be based upon all information available, most important of all being the past records of the business. Income statements are available usually for some time in the past. The more recent and the more frequent these statements, the more desirable they are. The books of record, together with the in-

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[50] P. B. Reed, *Adjustment of Fire Losses*, 1929, McGraw-Hill, New York. See pp. 178–191.

[51] Or the dispute may be settled by appraisal. Under the present forms, to delay the adjustment unnecessarily is unfair to the insured since he is not entitled to payments on account.

[52] By estimating *earnings* rather than by estimating the amount of net profit and fixed charges, consideration is automatically given to the policy condition that continuing expenses are covered only to the extent to which they would have been earned. In estimating earnings for a large or complicated loss the services of an auditor may be required.

ventory data which it may be necessary to prepare for use in adjusting the fire loss, may enable a statement to be drawn covering the period up to the fire. If not, it will be estimated in the same way as the probable earnings during the interruption. Data as to general business conditions, conditions in the particular trade of the insured, and conditions in his particular organization will be gathered if the loss appears large enough to necessitate it. Of the latter, volume of output during past periods or number of spindles in use at the time of the fire, unfilled orders and cancellations, hours of overtime worked, and the like are illustrative. When all of the desired information is assembled the income statements for past periods will be compared, the ratios of net profit, continuing expenses[53] and non-continuing expenses to gross profit will be ascertained and their trend and seasonal variation roughly approximated. The other information which has been gathered will then be considered in order to determine whether earnings and expenses would have increased, decreased, or remained the same.[54] Next the adjuster will prepare a statement of the estimated future income and expenses had there been no fire. This statement will cover the period of one year from the date of the fire if the form covering the risk is a coinsurance form, for this is necessary in order to determine the ratio of the insurance carried to that required. In this case the payroll of the insured for the ninety days following the fire will be separately estimated for the same purpose. If the risk is insured under a fluctuating form of policy the statement will be prepared for periods corresponding to those during which the limit of the insurer's liability is varied and will cover in total the period over which it is estimated the suspension will last. If the risk is insured under a straight per diem, weekly or monthly limit form the statement will be prepared only for the estimated period of the interruption.

Thus far the result attained has been a statement of the probable loss if the suspension of business is total during the

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[53] The individual items included within this amount would be determined as specified in Chapter II, pp. 55–61.

[54] "Agreement should then be reached with the insured as to the basis of the adjustment." Reed, supra, p. 180.

entire period. But in most cases the total interruption will be followed by the gradual resumption of business until the destroyed or damaged property can be repaired or replaced. The total loss, therefore, must be offset by calculating what the probable extent of the insured's earnings will be during the period. This will depend upon the nature of the damage done by the fire. The adjuster must estimate how long will be required to repair different portions of the property or how soon different machines can be placed in operation and the probable extent to which these repairs or replacements will allow the business to be resumed. In some of the earlier forms for manufacturing risks the basis upon which the extent of a partial suspension was to be estimated was by the proportion which the production prevented by the fire bore to the full daily production at the time of the fire (determined by taking the average of the daily production for a stated number of full operating days next preceding the fire).[55] The adjuster is no longer bound by such an arbitrary measure but may judge the extent of a partial suspension upon whatever basis he thinks best. Having done this, he reduces the estimated total suspension loss by the probable net earnings which will be realized as a result of the partial operation of the business.

It is also necessary to estimate the additional expenses, such as rent of temporary quarters, hire of equipment, overtime wages to plasterers, carpenters, electricians and others engaged in repair work, and extra costs required to obtain speedy replacement of destroyed machinery or equipment, which will be incurred by the insured in an effort to reduce the loss. Before the loss adjustment has been concluded the insured will have indicated, or the adjuster will have suggested, the cost of methods of reducing the loss. The earnings which it was estimated the business would realize during the interruption were conditioned upon the insured resuming operations as soon as possible and incurring the additional expenses necessary. These expenses were not included in the estimate for the continuing charges, the income statements having been prepared on the basis of the

[55] *Eastern Union Rules*, 1919, p. 61.

continuance of the business as though there had been no fire. It is necessary to estimate them separately and to determine, if the insured has already incurred some, that they will actually reduce the aggregate loss through reducing the period of the suspension or the amount of the loss within the period.

Just as in rent insurance the estimate of the period required to rebuild, repair or replace the damaged or destroyed property will usually be supported by the estimate of some competent party. If it appears evident that the repair of the building will take the most time, a reliable builder will be called upon to estimate it. If it appears evident that the machinery or equipment will take longer to replace, the estimate of an engineer may be utilized. Only in small losses will the replacement of stock be of paramount importance. The replacement of machinery in manufacturing risks frequently presents difficulties which the adjuster must consider. If standardized machinery is used in the particular business, it can usually be replaced quickly or repair parts can be obtained. Where the machinery can be obtained only through importation or only through construction on order, a considerable time may elapse before operations can be resumed. All these, and many other circumstances, must be considered by the adjuster, for an improperly estimated period of total or partial suspension will produce as serious consequences as an improperly estimated amount of net profit or continuing expenses.

If the loss is covered under a straight per diem form of insurance the estimated loss resulting from a total suspension of business will be divided by the number of days over which the total suspension is expected to last. This gives the actual per diem loss sustained. For each anticipated degree of partial suspension a loss has been estimated and this will be divided by the number of days over which each degree of partial suspension is expected to last. This gives the actual per diem loss sustained for each period of partial suspension. If these amounts are less than the respective per diem limits of the policy the loss will be paid in full. If the loss per day during the total suspension exceeds 1/300 of the amount of insurance, the limit of the policy is all that will be paid for each day of the total

suspension and the per diem recovery during each portion of the partial suspension will be reduced proportionately.

In addition to these payments the insured will receive in full the expenses which he has incurred for the purpose of reducing the loss, so long as the loss under the policy has been reduced. In other words the coinsurance provision of the partial suspension clause is not applied to these expenses. They are considered as additional expenses incurred wholly for the benefit of the insurance company. This is unfair to the insurer for if the insured is carrying only 50 per cent insurance the additional expenses which he incurs reduce not only the insurer's loss but also reduce that part of the loss which the insured must bear himself. Consider a case where the suspension would have been total and would have amounted to $500 loss per day. By incurring $100 per day additional expenses the loss can be reduced to $200 per day exclusive of these expenses. The insured is carrying $250 per day insurance. He would receive under the partial suspension clause 200/500 x $250, or $100 per day, plus the $100 additional expenses or $200 per day. Since his loss is $300 per day and his recovery $200 per day, his net loss amounts to only $100 per day. Though he was, presumably, a coinsurer to an equal extent with the insurer his loss is reduced to $100 per day and the insurer's to only $200 per day. Since both would have borne an equal part of the loss had it been total, the additional expense incurred should benefit the insured no more than it benefits the insurer. This could be accomplished if the additional expenses were added to the per diem loss sustained and the partial suspension clause applied to the total.[56] In this case the insured could recover 300/500 x $250 or $150 per day. His net loss would then be $150 per day, exactly the same as that of the insurer. He has then received only his proportionate share of the benefit from these expenses.

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[56] By revising the partial suspension clause to provide that the per diem liability should not exceed that proportion of the per diem liability that would have been incurred by a total suspension of business which the actual loss sustained (including such additional expenses necessarily incurred in reducing the loss under the policy) during the time of such partial suspension, bears to the per diem loss which would have been sustained by a total suspension of business.

If the loss had been covered under a fluctuating per diem form the loss would have been estimated by periods as set forth in the policy limits. The loss sustained during each period would have been reduced to a per diem amount and the same procedure then followed as was followed under the straight per diem form. If the weekly or monthly limit forms had been used the same principles apply in determining the insurer's liability.

Under the coinsurance form the amount of insurance required would have been found by extending the estimated income statement for a year from the date of the fire. That proportionate part of the loss (regardless of how it varied during the total and partial suspension) would then be paid which the insurance carried bears to that required. Any continuing payroll would have been considered separately but in the same manner.

Loss Adjustments—Illustrated.

To illustrate the application of the various forms let us assume that a business produces an annual use and occupancy value consisting of profits of $100,000 and unavoidable expenses of $200,000.[57] The business is totally suspended during 30 operating days and partially suspended during the following 30 operating days so that only 50 per cent of the normal earnings will be realized, after which time normal operations will be resumed. Since each form is designed for different circumstances the additional facts of each case will be varied.[58]

1. The straight per diem form.

If the $300,000 use and occupancy value were earned uniformly throughout the year the straight per diem form could have been used to cover the risk. The loss during the total suspension then would be estimated at $30,000 and during the partial suspension at $15,000.

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[57] Determined on the basis of the annual amount of the expenses which *will* continue during the period of suspension.

[58] The different forms have already been criticized and the cases to which they will not apply have been stated. The purpose here is to show how each form operates under the conditions to which it is particularly adapted.

If the amount of insurance carried were $300,000 the per diem limit would be $1000 and the insured would receive indemnity for:

30 days total suspension at..... $1000 per day = $30,000 (100%)
30 days partial suspension at....500/1000×$1000 per day = $15,000 (100%)

If the amount of insurance carried were $200,000 the per diem limit would be $666.67 and the insured would recover indemnity for:

30 days total suspension at
$666.67 per day = $20,000 (66-2/3%)
30 days partial suspension at
.....500/1000×$666.67 per day = $10,000 (66-2/3%)

2. The straight weekly form.

If the $300,000 use and occupancy were earned uniformly week by week but subject to daily variations within the week, the straight weekly form could have been used to cover the risk. The loss now would be considered to be $28,846.15 during the total interruption (since the business is considered to operate 52 weeks in the year or 312 days instead of 300 days) and $14,-423.07 during the partial suspension.

If the amount of insurance carried were $300,000 the limit per week would be $5769.23 and the insured would receive indemnity for:

5 weeks total suspension at.....$5769.23 per week = $28,846.15 (100%)
5 weeks partial suspension at
.....2884.614/5769.230×$5769.23 per week = $14,423.07 (100%)

If the amount of insurance carried were $200,000 the limit per week would be $3846.154 and the insured would recover indemnity for:

5 weeks total suspension at.....$3846.154 per week = $19,230.77 (66-2/3%)
5 weeks partial suspension at
.....2884.614/5769.230×$3846.154 per week = $9,615.39 (66-2/3%)

3. The coinsurance form (uniform earnings).

Regardless of how the use and occupancy value were earned, the coinsurance form might have been used. The amount of the loss during the suspension of business then might be estimated as amounting to 10 per cent of the annual value while the suspension was total (30 days being 10 per cent of the normal number of operating days in the year) and 5 per cent of the annual value while the suspension was partial. The aggregate loss would then be estimated to be 15 per cent of $300,000 or $45,000.

If the amount of insurance carried were $300,000 the insured would receive indemnity of:

300,000/300,000 of $45,000 = $45,000 (100%)

If the amount of insurance carried were $200,000 the insured would receive indemnity of:

200,000/300,000 of $45,000 = $30,000 (66-2/3%)

4. The fluctuating per diem form.

If the use and occupancy value would have been earned at the rate of $1500 per day during the first twenty days of the total suspension and at the rate of $1200 per day during the remainder of the period covered by the interruption the insurance could have been carried under a fluctuating per diem form. The loss would be estimated at $30,000 during the first twenty days of the total suspension, at $12,000 during the last ten days, and at $18,000 during the thirty days of partial suspension.

If the amount of insurance carried were such that the limits in the form were $1500 per day between the dates of the first twenty days after the fire and $1200 per day between the dates of the next forty days, the insured would receive indemnity for:

20 days of total suspension at .....$1500 per day = $30,000 (100%)
10 days of total suspension at .....$1200 per day = $12,000 (100%)
30 days of partial suspension at..600/1200×$1200 per day = $18,000 (100%)

If the amount of insurance carried were such that the limits in the form were $1000 per day between the dates of the first twenty days after the fire and $800 per day between the dates of the next forty days the insured would receive indemnity for:

20 days of total suspension at .....$1000 per day = $20,000 (66-2/3%)
10 days of total suspension at ..... $800 per day = $ 8,000 (66-2/3%)
30 days of partial suspension at 600/1200×$800 per day = $12,000 (66-2/3%)

5. The fluctuating weekly form.

If the use and occupancy value would have been earned at the rate of $9000 per week during the first four weeks of the total suspension and at the rate of $7500 per week during the remainder of the period covered by the interruption, the insurance could have been carried under a fluctuating weekly limit form. The loss would be estimated at $36,000 during the first four weeks of the total suspension, at $7500 during the fifth week, and at $18,750 during the five weeks of partial suspension.

If the amount of insurance were such that the limits in the form were $9000 per week for the four weeks immediately following the fire and $8000 per week for at least six weeks thereafter, the insured would receive indemnity for:

4 weeks of total supension at .....$9000 per week = $36,000 (100%)
1 week of total suspension at .....$7500 per week = $ 7,500 (100%)
5 weeks of partial suspension at
3750/7500×$7500 per week = $18,750 (100%)

If the amount of insurance were such that the limits in the form were $6000 per week for the first four weeks after the fire and $5000 per week for at least six weeks thereafter, the insured would receive indemnity for:

4 weeks of total suspension at .....$6000 per week = $24,000 (66-2/3%)
1 week of total suspension at .....$5000 per week = $ 5,000 (66-2/3%)
5 weeks of partial suspension at
3750/7500×$5,000 per week = $12,500 (66-2/3%)

6. The coinsurance form (fluctuating earnings).

Regardless of how the use and occupancy value would have been earned, the coinsurance form might have been used. The amount of the loss during the suspension of business. since the earnings fluctuate, could be estimated at any amount whatsoever, depending upon the circumstances. Suppose that the amount of loss had been estimated, as in the last illustration, at $43,500 during the time of the total suspension and at $18,750 during the time of the partial suspension, an aggregate loss of $62,250.

If the amount of insurance carried were $300,000 the insured would recover indemnity for:

300000/300000 of $62,250 = $62,250 (100%)

If the amount of insurance carried were $200,000 the insured would recover indemnity of:

200000/300000 of $62,250 = $41,500 (66-2/3%)

English Profits Insurance.

The English profits insurance system has been established to cover the same risk as that covered by use and occupancy insurance. Profits are defined as consisting of the net profit of the business plus the amount of the specified fixed charges. Indemnity is provided for their loss, and also for additional expenses incurred to reduce the loss. The policy incorporates virtually all of the provisions of the fire insurance policies on the risk by disclaiming liability unless the direct damage insurance shall have paid the loss or admitted liability. Profits insurance differs in one extremely important respect from use and occupancy insurance. It sets up in advance an agreed upon standard by which the extent of the loss shall be measured. The standard usually adopted is the turnover, but others, such as quantity output, value of output, number of machines in operation or volume of raw materials used, may be adopted to suit special circumstances. The ratio of the defined "profits" for the preceding year to the turnover, or other standard, for that period is determined. It is assumed that the ratio of the

"profits", as defined, to the turnover will remain the same regardless of any change in the volume of sales. This is based on the theory that prime costs, which can be discontinued or reduced after a fire, are always a fixed percentage of the turnover and vary in amount in direct proportion to its size. Since the sum of the prime costs, the fixed expenses and the net profit equals the amount of the turnover, the sum of the fixed expenses and the net profit earned therefore must always be a fixed percentage of the turnover. Changes in the turnover will bring about changes in the distribution of earnings between the fixed charges and the net profit, but the ratio of their sum to the turnover will remain unchanged. As a result the insured's loss may be determined by ascertaining the amount by which the turnover is reduced during an interruption and applying to it the percentage of "profits" to turnover established by operations of the past year. Since the insured may be carrying less than a full year's "profits", the insurer's liability is limited to that proportion of the lost turnover which the amount of insurance carried bears to the amount of the turnover for the twelve months immediately preceding the fire. This is called the "ascertained percentage," and by its application to the reduction in turnover the insured is required to carry 100 per cent insurance.[59] So long as the turnover remains below normal as a result of the fire, but not exceeding a stipulated number of days, the insured is entitled to compensation.[60] The period of indemnity is not limited by the time required to restore the damaged property but by the time required to bring the turnover up to normal without additional expense. Loss adjustments are not closed until then but the insured is usually entitled to payments on account during the time of the interruption. By not closing an adjustment until the interruption has ceased the conditions operating during the time of the interruption can be given due weight in estimating the probable turnover

[59] Additional expenses incurred to reduce the loss are recoverable in the proportion which the sum insured bears to the "profits" for the year preceding the fire. The insured is, therefore, a coinsurer for these expenses if the amount of insurance carried is inadequate.

[60] Premium rates are varied according to the maximum period of indemnity set forth in the form.

had no fire occurred. The actual turnover experienced during this period can then be deducted from it, and the reduction in turnover more accurately gauged.

The English system has the advantage of definiteness, leaving relatively little to the judgment of the adjuster and thus avoiding many disputes. But it lacks the flexibility allowed in the adjustment of losses in the use and occupancy forms. The rigid application of a predetermined measure of loss will result in inequity if conditions have materially changed at the time of the fire. Suppose that the price of a manufacturer's raw materials or his direct labor costs have been reduced, but that the selling price of his products has not been lowered. In other words, the proportion of prime costs to selling prices is altered. Though the volume of his turnover would not be affected, the amount of his net profits would be increased and the percentage of the sum of his profits and fixed charges to turnover would be higher than that of the previous period, and, consequently, higher than that allowed by the policy. If his loss were actually 40 per cent of the decreased turnover after a fire he would be allowed to recover only that lesser percentage, represented by the ratio of his past year's profits and fixed charges to the turnover for that period, which might have been only 30 per cent. The flexibility of the use and occupancy system is desirable in that more equitable loss settlements can be effected, but it requires better trained and competent adjusters.[61]

Power Plant Use and Occupancy Insurance and Power Interruption Insurance.

To provide coverage against interruption losses resulting from accidents occurring in the power plant of the insured or in that from which the insured derives his power, per diem forms of use and occupancy insurance have been provided by the casualty insurance companies which write direct damage insurance against the same power plant hazards.[62] These forms

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[61] In Canada both the use and occupancy insurance system and the English profits insurance system are provided for in the rules of the underwriters' associations.

[62] *Manual of Boiler, Engine and Electrical Machinery Insurance*, Indirect Damage Section.

differ from those in use in connection with other hazards in that they are valued, have a limit beyond which the insurer is not liable for any one accident, and may provide for a waiting period before liability attaches. The forms may provide for a constant daily indemnity or for a variable daily indemnity in the event of a total interruption. If there is a partial interruption, that portion of the daily indemnity is paid by which the daily production of the insured is reduced. The liability of the insurer continues until the interruption has ceased or the limit per accident has been paid. The limit per accident in the form was determined by the insured's estimate of the maximum number of days over which the business could be interrupted multiplied by the per diem indemnity. This, in effect, establishes a maximum period of indemnity for total interruptions, but not for partial interruptions. The insured may choose whether he desires indemnity to commence at the time of the accident or on a specified midnight following the accident. If he elects coverage commencing some time after the accident all liability for losses prior to that time is avoided by the insurer.[63]

Insurance against loss resulting from interruption of the insured's business as the result of accidents occurring "to the physical equipment of a public service system which immediately prevent, in whole or in part, the delivery of usable service" is provided under power or electric current interruption policies. These forms are similar to those just described except that the indemnity is payable for each hour (during the designated hours of each day on which the insured's plant operates) over which the service is interrupted. A limit per accident is fixed and a waiting period of fifteen minutes, for which no liability is assumed, is required.

Contingent Use and Occupancy Insurance.

Contingent use and occupancy insurance is the term used to describe the coverage which is afforded to an insured for loss

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[63] Rates per $1000 of daily indemnity are graded according to, (1) the type of equipment covered; (2) the number of days of indemnity; and (3) the length of the waiting period.

resulting from the interruption of his business caused by the damage to or destruction of property belonging to others by the hazard insured against. These properties may be (a) outside power plants from which he obtains power, (b) plants furnishing materials or parts necessary for the continuance of his business, or (c) plants to which the product of the insured's plant is sold. This form of insurance is written on the usual use and occupancy insurance forms, but is written separately from the form covering the use and occupancy value of the insured's own property.[64]

Use and Occupancy Insurance Rates.

The use and occupancy insurance hazard depends upon the probability of the occurrence of fire,[65] upon the probable length of time over which an interruption to business will last, and upon the probable extent of the suspension of business which a fire will occasion. The fire insurance rate on the property whose destruction or damage will cause the interruption loss is the best available measure of the probability of the occurrence of fire, so it is always used as a basis for use and occupancy insurance rates.[66] The length of time over which an interruption may continue is dependent upon the character of the property covered. The time required for its replacement or repair is independent of its susceptibility to fire and must be considered separately. Well constructed buildings, less susceptible to fire, will usually require longer for their repair or replacement than poorly constructed buildings and, consequently, the use and occupancy rate should be higher in proportion to the fire insurance rate for the former than for the latter. The same consideration must be given to the factors affecting the time required to replace equipment, machinery and stock, if stock is

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[64] Except where the hazard is that of plants furnishing power, in which case the additional coverage may be obtained by endorsement.

[65] Or whatever peril is insured against.

[66] Subject to the same criticism as when used as the basis for rent insurance rates. See pp. 103-104.

covered. The probable extent to which the business will be suspended depends upon the interdependence of various units of the business. For a manufacturing concern the suspension of only one process may necessitate the suspension of the entire business. If this particular process embodies a severe fire hazard the rate for use and occupancy insurance will necessarily be increased.

Mercantile risks, being a more uniform group than manufacturing risks, are usually subject to class rates though specific rates may be promulgated if special conditions, such as the use of two or more buildings, make it desirable. Risks using machinery, except for building service or for auxiliary processes in connection with a mercantile occupancy, must be classed as manufacturing risks and for these specific rates are prepared.[67] For mercantile risks rates for each type of form used depend upon (a) whether interruption for the time required to replace stock is included or excluded, and (b) whether more or less than 50 per cent of the total floor area is of fire resistive construction. If stock replacement is covered the basis rate used is the average of the fire insurance rates[68] for the building and the contents. If stock replacement is not included, the basis rate is the fire insurance rate for the building alone. If 50 per cent or more of the floor area is of fire resistive construction a higher percentage of the basis rate is taken than if less than 50 per cent of the floor area is of such construction, in this way giving consideration to the probable longer period of time required to restore the better constructed risks. But no consideration is given to the difference in time which would be required to restore each of two buildings of the same type but of different size. Nor is the greater length of time required to replace certain kinds of stock allowed to affect the rate. If the coverage is under the per diem form a lesser percentage of the basis rate is

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[67] This is true for the major portion of the country. The various rating bureaus or associations have, in some respects, departed from the specific rules of the Eastern Underwriters' Association but have followed them in principle. The New York Fire Insurance Exchange has departed radically in that all rates are based on the insured's highest contents rate and no allowance made for unusual features of the risk.

[68] Usually the 80 per cent coinsurance rates.

taken for each class of construction than if the coverage is on the weekly form, the resultant rate for the latter being about 15 per cent higher than for the former.[69]. Where the monthly limit form is used it is written only at rates determined in the same way but relatively higher than for the weekly limit forms. The coinsurance form for mercantile risks is written at rates on the basis of the fire insurance rate for the building if stock replacement is limited to thirty days, but at rates on the basis of the average of the fire insurance rates on the building and contents if stock replacement is extended beyond thirty days. Different rates are charged for the coverage granted on net profits and continuing expenses and for that on the payroll, 80 per cent of the fire insurance rate being charged for the former item and 125 per cent for the latter. The reason for this difference is that the amount of insurance required is the annual value of the former but only the ninety day value of the latter since the insurer's liability for payroll is limited to ninety days. Since

[69] The following class rates for mercantile risks, taken from the *Eastern Underwriters' Association Rules* (p. 64) are illustrative,

	COVERING BLDG. AND MACHINERY AND/OR EQUIPMENT	COVERING BLDG. AND MACHINERY AND EQUIPMENT AND STOCK OR STOCK ONLY
PER DIEM FORM		
(a) If 50% or more of floor area, including basement and sub-basements, is of fire-resistive construction, 70% of	80% Co-ins. Building Rate	Average of 80% Co-ins. Building and Contents Rates
(b) If less than 50% of floor area, including basements and sub-basements, or if none of building is of fire-resistive construction, 65% of.	80% Co-ins. Building Rate	Average of 80% Co-ins. Building and Contents Rates
WEEKLY FORM		
(c) If 50% or more of floor area, including basements and sub-basements, is of fire-resistive construction, 80% of	80% Co-ins. Building Rate	Average of 80% Co-ins. Building and Contents Rates
(d) If less than 50% of floor area, including basements and sub-basements, or if none of building is of fire-resistive construction, 75% of..	80% Co-ins. Building Rate	Average of 80% Co-ins. Building and Contents Rates

there will be a greater number of interruptions of ninety days than for longer periods of time (up to a year) the rate for the coverage of this item must be higher. The rate, in proportion to the annual value of the payroll, is less than that for the other items because of the fact that these other items will continue for at least the same length of interruption as that for which the payroll would continue, and may continue for longer, whereas the payroll can not continue beyond ninety days.[70] Rates for the coinsurance form average higher than those for the periodic limit forms because of the possibility of abnormal losses occurring for which the insurer will be fully liable but for which his liability would not have exceeded the limits set forth in the other forms, and also because of the additional coverage granted on payroll.

Manufacturing risks are specifically rated by the application of a schedule to the facts set forth in the inspection report of the risk. Uniform inspection reports had been developed by the Fire Underwriters' Uniformity Association.[71] Those things affecting rates with which the inspection reports are concerned are the special features of the risk from the standpoint of the effect of a fire, (a) upon the process of manufacture, determined by the degree of interdependence of processes and the fire hazard of each process, (b) upon the type of machinery used, determined by its susceptibility to fire and the speed with which it can be replaced, (c) upon the power supply, determined by the dependence of each portion of the process upon each source of power supply, the fire hazard of the power plants and the possibility of their rapid replacement or the substitution of power from some other source, and (d) upon the stock, determined by its susceptibility to fire if separately stored and the time within which it can be replaced, if stock replacement is covered.

The schedule used for determining the use and occupancy rate uses as a basis a percentage of the fire insurance rate on the building, 80 per cent if 50 per cent or more of the floor area

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[70] If it should the insurer is not liable.

[71] Its activities were indefinitely suspended in May, 1925, since its functions duplicated those of the National Board of Fire Underwriters and the local rating associations.

is of fire-resistive construction, 70 per cent if less than 50 per cent of the floor area is of fire-resistive construction. Additions to the basis rate in the form of percentages, are made (1) for machinery, 50 per cent if it is not obtainable in the domestic market, 20 per cent if it is obtainable in the domestic market but only as made on special order,[72] (2) for deficiencies in the process of manufacture, 20 per cent if the process is so interdependent that the crippling of one machine or process would cause an interruption of the whole process, and an additional 20 per cent if the process involves the picking of cotton stock. This gives the gross rate for a form contemplating only building, machinery and equipment replacement. The net rate for a form of the same type is found by deducting a percentage of the basis rate for special power features of the risk. The gross rate is based on the assumption that all of the insured's power comes from his own plant and that the whole process of manufacture would be interrupted were this source of power interfered with. If the machinery in different divisions of the plant is separately operated by power generated in a separate fire division of the plant a credit of 10 per cent is allowed. If two or more groups of machines are separately operated by power generated in separate fire divisions the credit is 5 per cent. If there are two or more independent sources of power, each sufficient to operate the whole plant, and not subject to the same fire, a credit of 10 per cent is made, but reduced to 5 per cent if credit has been given under either of the preceding two heads and to zero if all of the insured's power is generated outside. If stock replacement is to be covered by the form a charge of 50 per cent of the basis rate is made if the supply of stock is available only seasonally or not readily obtainable in the open market. The result is the net rate for a form covering interruptions for the time necessary to replace buildings, machinery, equipment and stock.

For risks made up of several buildings not considered a single fire risk, average use and occupancy rates are prepared.[73] For

[72] An additional charge is sometimes made if the machinery is light and susceptible to damage.

[73] Average rates may not be used for independent use and occupancy risks operated by the same insured. Average rates are only used for use and occupancy risks which are a unit but composed of several properties or units dependent upon each other.

mercantile risks the rate is found by weighting the use and occupance rate of each fire division (found by reference to the class rates already described) according to its floor area and striking an average. For manufacturing risks the average rate is found by ascertaining the rate for each building according to the described schedule. All buildings are then grouped under four classifications, (1) Power plant, (2) Buildings with processes requiring machinery, (3) Buildings with hand work processes only, and (4) Storehouses. Average rates for each classification are then found as they were for mercantile risks. To find the average rate for use and occupancy insurance for the entire plant the rate found for each class of property is weighted and an average taken. To require an average rate the plant may consist of buildings falling within two, three or all four classes. The weights will vary, then, depending upon how many classes of buildings make up the plant. The weights applied are set out in the following table:

Power plant	30	31	35	—	38	—	—	—
Buildings with machine processes	50	53	59	80	62	95		85
Buildings with hand processes only	15	16	—	15	—	—	75	15
Storehouses	05	—	06	05	—	05	25	—
Total weight	100	100	100	100	100	100	100	100

The use and occupancy rate finally determined is the rate which will apply if the risk is covered under one of the per diem limit forms. The only other form available to manufacturing risks is the coinsurance form and the rates for this are based upon the per diem rate. For the portion of the insurance covering on net profit and continuing expenses, the per diem rate is increased 20 per cent. For the coverage of payroll, the rate just determined is increased 50 per cent. These rates are approximately as much higher than the per diem rates as were those for mercantile risks.

The rating system for use and occupancy insurance is a judgment system, subject to all of the deficiencies of such a

system. There is such an extreme degree of difference in the details affecting different risks that not all can be taken into consideration in determining the rate. Use and occupancy insurance experience, even were it available, could not be so minutely classified as to measure the difference in risk caused by these minor variations between risks. But separation of the use and occupancy insurance loss data from that of the direct fire loss data would aid materially in determining the weight to be given to such major differences between risks as the time required to reinstate a risk. While this is taken into consideration in the class rates for mercantile risks, and even more so in the schedule rates for manufacturing risks, the difference in time required to rebuild specific properties of the same or different classes is not considered at all. This is a major factor affecting the risk and should be provided for. Even those differences in rate allowed between risks which are to a large degree, and those which are to a lesser degree, of fire-resistive construction are not supported by adequate data. The throwing of use and occupancy insurance experience together with the direct damage insurance experience into a classification based solely on the nature of the occupancy of the property handicaps the development of independent use and occupancy insurance rates. Fire and use and occupancy losses bear no definite relation to each other in point of size, the relationship being merely one of cause. The use and occupancy hazard and the fire hazard are distinct and separate; the experience developed from their insurance should be kept just as distinct and separate. Some few of the larger insurance companies have separated their experience with each line for their own information, but the separation alone is not sufficient. The experience must be separately classified, not merely according to occupancy, but according to those other elements of hazard which make use and occupancy insurance differ from the direct damage lines.

Conclusions as to Use and Occupancy Insurance.

Use and occupancy insurance is a fast growing line and, serving a definite economic need, will continue to increase in importance.

The forms under which this insurance is written are adequate, the coinsurance forms, without the imposition of artificial limits upon the insured's ability to recover, allow him as complete protection as it is possible to offer. So long as the insured may choose a coinsurance form, no harm is done by allowing him to choose the less advantageous periodic limit forms. Improvements in the coverage are possible, among them being the removal of the stock in process replacement provision, the extension of the period of indemnity beyond the period required for the replacement of the property damaged or destroyed, and the application of the coinsurance provision to the additional expenses incurred by the insured for the purpose of reducing the loss. Provision also should be made in the insurance forms to entitle the insured to payments of mutually agreed upon amounts at intervals during the suspension of his business when the adjustment of the loss is delayed for any reason.[74] Loss adjustments then could be handled more equitably by paying at intervals the estimated amount of the loss, postponing the final adjustment until the interruption has ceased and the actual conditions under which the insured would have operated can be determined more definitely. It is also to be hoped that data relating to use and occupancy insurance will be separately classified so that more accurate methods of rating specific risks, with less possibility of inequity, may be devised.

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[74] This is done in some cases by different insurance companies.

V

Profits and Commissions Insurance

Profits and commissions insurance, as the term is now used, is that form of insurance which protects against the loss of profits upon finished goods held by the manufacturer of the goods or against the loss of profits or commissions upon special or consigned stocks held in storage. This insurance may be written to cover against any of the insurable hazards to which the merchandise itself is subject. The coverage is accomplished by means of forms attached to a direct damage policy, but it must be written separately and not in conjunction with the insurance on the goods themselves.

Profits and Commissions Insurance Considered as Business Interruption Insurance.

There are several reasons why this form of insurance may be considered as a class of business interruption insurance. From an historical point of view the principle of profits and commissions insurance is the original principle upon which the coverage against business interruption loss was written. Chômage insurance in 1860 embodied the payment of an additional amount in proportion to the amount of damage done to insured property. This is the principle of some of the present profits and commissions insurance forms. The difference between the two lies in the fact that the present forms are restricted in their application to merchandise, whereas the chômage forms were applicable to buildings or to stock. Secondly, whether the coverage is applied to goods in the hands of its manufacturer or to goods held in storage for sale on commission, the loss resulting from their destruction is a business interruption loss. Were the insurance applied to the profits in the stock of a retail merchant there would be no question as to its serving as coverage for a business interruption loss. Destruction of the stock would

interrupt the merchant's sales, *i.e.*, his business, and the insurance would provide reimbursement for the profit he would have made out of his business when he sold the goods. But his true loss is not measured by the stock of goods he had on hand and which were destroyed, but by his loss of sales till the goods have been replaced. This replacement may be accomplished before the destroyed goods would have been sold so this form of insurance is denied him in favor of use and occupancy insurance.[1] The situation of a commission merchant is similar save that if the goods are destroyed his chance of realizing his commission (the profit of his business) is probably forever lost. Even if the goods can be replaced, it can be assumed that they would have constituted another consignment to him on which he would have realized another commission. The retail merchant must sell his goods above their cost in order to realize a profit, but the commission merchant receives his commission no matter what the price at which he sells his consignments. Since the commission merchant is not restricted in the price at which he can sell the goods to the same extent as is the retail merchant, it is presumed that he could have realized his commission on the goods destroyed in addition to those which he actually realized on other sales.[2] His commission is forever lost, his business is interrupted not in point of time, but in point of earnings. For him, then, profits and commissions insurance is business interruption insurance. The manufacturer of goods which he still holds, suffers a business interruption loss upon their destruction in that the profit which he would have realized from their sale is forever lost to him. To replace this loss he would be required to utilize his plant facilities in the production of goods to take the place of those destroyed. Had the loss not occurred his efforts would have produced goods on which another profit would have been made. The time required for their reproduction is, in reality, lost time and his loss is a business interruption loss.

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[1] The reasons for this are more fully presented in Chapter II, p 64.

[2] The absence of a moral hazard in that the goods are usually not in the custody and control of the commission merchant, makes this form of insurance on his interest permissible, whereas it would often be impossible to cover if the insured had control of the goods.

Early Coverage.

The early history of the insurance of profits or commissions on goods against other than marine perils can not be determined. Two reasons may be assigned for this. First, valued policies on goods were written frequently, and where the policy is valued profits can be covered without their designation as such. Second, the coverage of profits or commissions, when specifically assumed, probably was written in conjunction with the insurance on the goods, consequently being relegated to an unimportant position and considered of relatively little significance.[3] Of this there is an illustration. In, or before, 1882, a policy was written on imported merchandise contained in a warehouse where it was held for sale on commission. The insurer assumed responsibility for the damage to the goods promising to pay any loss "upon the basis of the actual cost thereof as shown by foreign invoices, with exchange, duties and all charges added up to the date of such loss, *including also*. . . . (per cent) *selling commissions thereon.*"[4] What the extent of the coverage under this form was intended to be in case of a partial loss is not determinable. If all, or a portion, of the goods were completely destroyed, the additional percentage of the value of the destroyed goods was payable, but if the goods had a salvage value, the additional percentage might have been considered to be payable upon the amount of the net loss thereon or upon the whole value of the goods.

In 1911 a profits and commissions form in which the rate of profits was agreed to be not exceeding 15 per cent on the sound value of the merchandise, was viewed and construed by a New York court.[5] The policy provided for a measure of the loss of profits on the basis of the loss sustained on the goods. The insuring clause held the company liable for the "loss of commissions and/or profits equal to not exceeding 15 per cent of

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[3] But the New York Fire Insurance Exchange, as early as 1895, prohibited the inclusion of commissions coverage in policies covering on merchandise—*Rules of the Tariff Association of New York*, 1895.

[4] C. C. Hine's *Book of Forms*, 3d Edition, 1882, Form No. 81, p. 36.

[5] Page v. Northern Ins. Co. of N. Y. (N. Y. S. Ct. App. Div.) 125 N. Y. Supp. 1066, January 2, 1911.

the amount of damage which such goods shall be found to have sustained, which damage shall be the final cost to the companies covering the stock, irrespective of whether the stock is surrendered to the companies insuring the same or not." It was held that this provision limited the insurer's liability to an amount not in excess of 15 per cent of the difference between the total value of the goods and the amount received on the salvage which was taken over by the insurers on the goods. In other words the profit which the insured could claim was not a percentage of the amount paid by the insurers on the goods, but of the amount of the actual damages sustained on the goods.

Prior to 1912 no attempt had been made to standardize to any extent the writing of profits and commissions insurance, or the forms to be used. The various underwriters' associations had the briefest of rules, usually providing only that the insurance should be written at the rate and rules applying to the merchandise itself. That the coverage was granted to merchants or dealers is evident from the wording of some of the clauses covering "on the net profits derived from their business as dealers in ———— contained in building situated ————, on *profits from their stock in trade, their own* or held by them in trust or on commission or sold but not delivered."[6] Valued forms were used as well as those which were unvalued. The lack of specific regulation on the part of the underwriters' associations allowed each insurer to use whatever forms it deemed advisable.

Promulgation of Uniform Forms.

To bring some order out of the chaotic condition in which profits and commissions insurance found itself the New York Fire Insurance Exchange, in 1914, promulgated two standard forms for the coverage of the risk. The use of other than these forms was not prohibited but was discouraged by the fixing of a rate for such deviating forms at three times the rate

[6] See W. B. Medlicott, *Lectures Delivered Before the Insurance Institute of Hartford, Conn.*, p. 105, where this form was recommended as a good form, in spite of the further fact that it was valued.

for that of one of the recommended forms. The forms which were then devised, except for the addition of a clause to one of them, are those which are still in use.

Other underwriters' associations were more backward in the suggestion of uniformity in these forms. Some of the associations in the east approved forms corresponding to those of the New York Fire Insurance Exchange,[7] but no attempt was made to secure uniformity throughout the section, much less throughout the country. In 1924 the associations having jurisdiction in the Midwestern territory adopted the forms of the New York Fire Insurance Exchange almost verbatim.[8] In 1926 the present forms, substantially the same as those now used in the East, came into existence. Until the Eastern Underwriters' Association superseded the Eastern Union in 1927 no forms for the writing of this class of insurance had been incorporated into its rules. Consequently the majority of the local associations had done nothing. When the new rules of the Eastern Underwriters' Association appeared in 1927 two forms but slightly different from the New York Fire Insurance Exchange forms were recommended[9] and since then the local associations have been putting them into effect. The Board of Fire Underwriters of the Pacific has not incorporated specific forms into its rules, but requires compliance with certain requirements which tends toward unification in the Pacific territory.[10]

Description of the Interest Covered.

The forms which are used today in different sections of the country differ in their description of the interest which the form is intended to cover. The interest may be described as consisting

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[7] *Southeastern Underwriters' Association Rule Book*, 1920, p. 213. *Boston Board of Fire Underwriters. Underwriters' Book of Forms*, 1924, p. 45.

[8] See the rules of any of the associations for 1924, specifically those of the *Illinois Inspection Bureau*, 1924, pp. 45–46. But the forms covered net profits rather than merely profits.

[9] *Eastern Underwriters' Association Rules*, 1927, pp. 14–16.

[10] *Board of Fire Underwriters of the Pacific Rules*, p. 19C. The Washington Surveying and Rating Bureau has adopted one of the New York Fire Insurance Exchange forms and the Standard Forms Bureau of San Francisco publishes a uniform form.

of "the profits and/or commissions on finished merchandise, sold or unsold, . . . ", or of "the *net* profits and/or *net* commissions on finished merchandise, sold or unsold, . . . " The former description is contained in the forms in use in the Eastern territory and in those used in the Pacific territory, the latter is found in the Midwestern and in the Southeastern forms. In none of the prescribed forms are the terms "profits" and "net profits" or the terms "commissions" and "net commissions" specifically defined. When the term "profits" is used unqualifiedly, it has been held that the policy covers the *gross* profits which would have been realized from the sale of the goods *at the time of the fire*, and that none of the expenses of conducting the insured's business could be deducted.[11] But even when the form specifically provides that the interest covered is the "net profit" on the goods, there is no method set forth for determining its amount. Ordinarily the measure of an insured's loss of profit would be the difference between the selling price of the goods and their actual cash value at the time of the fire, less the expenses necessary to put the goods on the market since these expenses are avoided upon the destruction of the goods. The actual cash value of the goods at the time of the fire is the measure by which the insured's recovery under his fire insurance policy is determined, and their selling price at the time of the fire, less the expenses of selling them, represents the amount which he could have received for them. The difference, then, will be the true measure of the profit lost.[12] Where there is no specific definition of the term it is evident that an insured might

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[11] States Import and Export Corporation v. Hartford Fire Insurance Company, (Supreme Ct. Appellate Division) 206 N. Y. Supp. 323. The policy involved was a standard New York Fire Insurance Exchange form.

[12] In some forms which were used before uniform forms were adopted this meaning of the term, profit, was incorporated, with the exception that the expenses which could be avoided were not deducted. See *Underwriters' Book of Forms*, 1925, Form 148 and Form 149. In forms used in New England the liability of the insurer was limited to a *stipulated* percentage of the damage to the merchandise, the insurance required being based upon this percentage of the actual cash value of the merchandise at the time of the fire. By implication the profits on the merchandise were defined as being the stipulated percentage of its actual cash value. It must not be inferred from this that the policies were valued. At the present time the Chicago Board of Fire Underwriters provides a standard form in which the term is defined but not reduced to a *net* basis.

claim as his loss of profits the difference between the price at which the goods could have been sold and the cost which he actually incurred in their acquisition. This claim would be made when the cost of replacing the goods would be greater than the actual cost incurred, *i.e.* when the goods had increased in value. But this is not the true measure of his loss, for the profit which has accrued through the increase in the value of the goods is recoverable under the fire insurance policy on the goods themselves. There is a question as to whether or not a claim of this nature would not be sustained at law, for the term, profit, is ambiguous. The situation could be remedied easily by stipulating that the profits insured under this policy shall be considered to be the difference between the market price and the actual cash value at the time of the fire of the merchandise described herein, from which shall be deducted those expenses which would have been required to effect the sale of such merchandise but which may be avoided by the insured as a result of the fire.

The term commissions does not lend itself so readily to misconstruction. If the coverage of the policy is not specifically restricted to the *net* commissions on merchandise it will extend to cover the *gross* commissions which would have been realized on the sale of the goods. This would necessarily follow were the court to be consistent with its decision that insurance on profits on merchandise covered gross profits without deduction for expenses. To avoid this possibility the term commissions should be defined to mean the commissions at the rate and on the amount which would have been received had the merchandise been sold in an undamaged condition at the time of the fire, from which shall be deducted those expenses which the insured would have incurred to effect the sale of such merchandise, but which may be avoided as a result of the fire.

Provisions for Coinsurance.

The provision which is made for the incorporation of the principle of coinsurance into the various forms for the insurance of profits and commissions varies in the different territories. In the East no coinsurance provision appears in the form itself.

The usual form of coinsurance clause may be attached thereto, and it is frequently made compulsory. The rules of the New York Fire Insurance Exchange make the use of at least an 80 per cent coinsurance clause obligatory.[13] Those of the Southeastern Underwriters' Association require the same percentage of coinsurance as that required for insurance of the merchandise but not less than 75 per cent, the coinsurance clause being incorporated as a part of the profits and commissions insurance form itself.[14] In the Midwestern territory the use of a coinsurance clause was optional but the clause was included in the forms of some rating bureaus until recently.[15] The Board of Fire Underwriters of the Pacific requires that a 100 per cent coinsurance clause be made a part of each policy.[16]

When a special coinsurance clause is included within the terms of the form the amount of insurance required is a stipulated percentage of the (net) profits and/or (net) commissions which would have resulted from the sale of all merchandise on hand at the time of the fire. When no special clause has been provided, the same form of the clause is used as that which would be attached to a policy covering on the merchandise. This clause requires an amount of insurance equal to the stated percentage of the actual cash value of the property described, which might be construed to mean either the value of the merchandise described or the value of the profits or commissions upon it. To remove this possibility the forms always define the word "property" as used in the policy or in the clauses attached to it to mean the profits and/or commissions on the merchandise described.[17]

The indefiniteness as to whether a form covering on "profits and/or commissions" is intended to cover the gross or the net loss of the insured makes equally indefinite the amount of insurance which the insured may be required to carry. Where the interest is described as the "net profits and/or net commissions" on the merchandise the insured is still confronted

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[13] *Rules*, p. 66.
[14] *Rules*, p. 213A.
[15] See *Wisconsin Inspection Bureau Rules and Forms*, 1927. The clause was deleted in May, 1929.
[16] *Rules*, p. 19C.
[17] Or net profits and/or net commissions.

with the problem of determining upon what basis the net profits on the goods will be measured. He will, however, be fully protected if he carries insurance to an amount equal to the difference between the cost of replacing the goods and their net selling price at the time of the fire, for that will determine the amount of his actual loss. If he finds that the insurance requirement is construed to mean the difference between the amount which the goods actually cost him and that which he can realize net from their sale, the deficiency in the amount of insurance which he would be carrying if the goods had cost him less than their present replacement value, would be counterbalanced by the larger amount of loss which he could claim.

The same analysis holds true with reference to the expenses which may be avoided. If the policy covers the profits which would have been realized upon the sale of the goods the amount of insurance required would be based upon the gross profits lost, and, though the amount of insurance would be insufficient if only the net profits had been insured, the deficiency in the amount of insurance would be counterbalanced by the larger claim which could be made for the amount of the gross loss as compared with the actual net loss. When the loss is only partial and the expenses of packing, handling, labeling and shipping the damaged merchandise, as well as the commissions paid upon its sale, can not be avoided the insured will be reimbursed for their amount through the increased price obtainable for the salvaged goods.[18]

Those expenses which can not be discontinued upon the complete or partial destruction of the merchandise, and which are not directly dependent upon the value of merchandise handled, must be included in the amount insured. If, for example, the manufacturer rents a warehouse, or if his salesmen are paid on a salary and commission basis, the amount of the rent and of the salaries will continue in spite of the fact that there are no goods to be sold. These expenses would have been met out of the profit which would have been realized had the goods

[18] The possibility of actually realizing these expenses, and the same rate of profit upon the damaged goods as would have been realized upon the goods in an undamaged condition, will be considered later. See pages 205 and 206.

been sold. By defining profits, or net profits, as the difference between the market price and the actual cash value of the goods at the time of the fire, deducting only the expenses which would have been required to effect the sale of the goods and which may be avoided, the amount recoverable and the amount of insurance required would include the continuing expenses to their full amount. If a fire occurred and completely destroyed the goods so that it would be possible to discontinue the payment of rent, salaries, and similar expenses, the amount of the loss which could be established under the insurance would be reduced by the amount of the rent or salaries for the time which would have been required to dispose of the goods in the usual course of the insured's business. Since these expenses are now avoidable they are excluded from the insured profits as defined above, and the amount of the insurance required is correspondingly reduced. Since partial losses are much more likely to occur the insured should not base his estimate of the amount of insurance required upon conditions which would exist only if the merchandise were completely destroyed or substantially damaged, but should insure to an amount determined by his profit as defined above, deducting only the expenses to the extent to which they may be avoided should only a partial loss occur. Hence, the amount of insurance required may again be greater than the total loss which could be suffered.

A variation in the nature of the coinsurance requirement is embodied in forms used in New England. In these forms the insurer's liability is limited to a specified percentage of the damage sustained by the merchandise. This percentage of the value of the entire merchandise at the time of the fire is assumed to be the maximum loss of profits which could be sustained by the insured. No special form of coinsurance clause is used but the term, property, is defined as meaning the stated "percentage of the actual value of the merchandise described."[19] If the profits recoverable under the policy were stipulated to be an amount not exceeding 20 per cent of the damage sus-

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[19] Uniform Standard Form for Boston and New England Conference Form XC.

tained by the merchandise, and if an 80 per cent coinsurance clause were attached, the clause would be interpreted as requiring an amount of insurance equal to 80 per cent of 20 per cent of the actual value of the merchandise at the time of the fire. In other words, insurance to the extent of 16 per cent of the value of the merchandise would be required at all times regardless of what variation there might have been in the profit which the insured could have realized from its sale. If the replacement value of the goods increased but their market price did not increase in the same proportion the insured's rate of profit on the value of the goods would be reduced, but the same amount of insurance as before would be required.[20] The defect of this is apparent, for the amount of insurance required bears no uniform relation to the actual amount at risk. When conditions are such that the insured can realize a profit of 20 per cent on the value of the goods the insurance required will be 80 per cent of the amount at risk; when a profit of only 15 per cent can be obtained, 106-2/3 per cent insurance is required; if a profit of 25 per cent can be made, only 64 per cent insurance is necessary under the clause, but the provisions limiting the insurer's liability to not over 20 per cent of the damage sustained by the merchandise precludes his recovery for more than 80 per cent of his loss. For the amount of insurance required to be uniformly 80 per cent of the amount at risk, as is intended, the ratio of the insurance to the value of the goods in each of the preceding cases should be respectively 16 per cent, 12 per cent and 20 per cent.

Types of Forms.

The different forms for the coverage of the interest in profits and commissions are of two types, (1) those in which the amount of the loss is determined in proportion to the damage sustained on the merchandise, and (2) those in which the amount of the

[20] The same situation would arise where several classes of goods were covered and the rate of profit on one was 30 per cent and on the other 20 per cent. If any change should occur in the proportion of the value of one class as compared with the other, the average rate of profit would be altered but the same proportionate amount of insurance would be required.

loss is not so limited. The difference between the theory of these two classes of forms may be illustrated briefly as follows. Suppose a manufacturer has 1000 units of goods, the value of which amounted to $5000 at the time of the fire and on which, it is agreed, a profit of $1000 would have been realized had they been sold in an undamaged condition on the day of the fire.[21] If the fire destroys 300 units, damages 200 units to the extent of 50 per cent of their value, but leaves the remainder intact, what is the amount of profits which will be lost? Forms of the first type assume that the full rate of profit will be realized on the entire amount of salvage. The rate of profit would have been 20 per cent had no fire occurred. On this assumption $500 profit will be realized from the 500 undamaged units and $100 profit will be realized from the sale of the 200 units of the goods which had suffered a 50 per cent damage. The loss is, then, $400. The damage suffered by the merchandise was equivalent to 40 per cent of its value and the loss of profits is likewise considered to be 40 per cent of the amount of the profits which would have been realized. Under forms of the second type no such basis for determining the proportionate loss of profits in case of a partial loss is established. The form merely limits the recovery to the amount of profit which would have been realized if the damaged or destroyed goods had been sold in an undamaged condition on the day of the fire. Since 500 units of goods were destroyed or damaged the loss may be ascertained to be any amount up to $500. There is no presumption that the same rate of profit will be realized upon the sale of the salvage as would be realized upon the sale of undamaged merchandise. There will be no difference between these forms when the loss is occasioned by the total destruction of the goods, but when the loss on the goods is only partial, the first form will always result in the payment of an amount either less than, or at most equal to, that which would be received in the same case under the second form.

The presumption that damaged goods can be sold at the same rate of profit as could undamaged goods is not in accordance with fact. In the majority of cases the damaged goods must be

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[21] No method of determining this amount is set forth in the forms, but both forms contain this limit upon the insurer's liability.

sacrificed at a price which will allow little or no profit to the insured. Even if the goods can be reconditioned the cost of reconditioning will frequently be sufficient to preclude the possibility of as large a profit as would have been realized on sound goods, though the rate of profit may be greater than if the goods had not been reconditioned. A loss of profits bears no necessary relationship to the amount of damage done to the goods, for to sell goods damaged to the extent of 50 per cent of their value at a profit of 20 per cent on their present value usually will be much more difficult than to sell goods damaged to only 25 per cent of their value at a profit of 20 per cent. Where the salvage is taken over by the insurers on the goods the insured loses all the profit which he might have made, and which it was assumed under the first type of form he would have made, upon the sale of the salvage. Referring to the previous illustration, if the insurance company takes over the 200 units of goods which were 50 per cent damaged, the insured will receive for them their value of $1000. On them he would have made a profit of $200 had they not been damaged. Under his policy on profits, however, he is allowed only $100 of this profit since the goods were only 50 per cent damaged. The remaining $100 of profit, which it was assumed he would have realized upon the sale of the salvage, is lost to him because of the taking over of the salvage by the insurers. To assume, then, that a loss of profits on goods will be in direct proportion to the damage done to the goods is erroneous and forms of the first type, which limit the insurer's liability to that proportion of the loss of profits which the amount of damage suffered by the merchandise bears to the sound value of such merchandise at the time of the fire, do not, generally, provide the insured with sufficient indemnity to reimburse him for his full loss. The second type of form, in which the insurer's liability is limited only by the amount of profit which could have been realized from the sale of the damaged goods in an undamaged condition on the day of the fire, provides sufficient protection to cover the insured's full loss.

There is the possibility, on the other hand, that either type of form, especially if misapplied, would allow the insured to recover

more than his actual loss. Under both forms the limit upon the loss of profits is that profit which would have been realized from the sale of all of the merchandise on the day of the fire. If the stock of goods which has been damaged or destroyed could be replaced without loss of time and without additional expense, but the quantity of goods on hand had been so large that considerable time would have been required to sell them, or if the selling price of the goods was declining so that the insured would have been able to sell some of them only at the decreased prices later on, the insured's loss would be less than that which it is assumed to be under either form. Part of this condition is cared for in forms used by the Chicago Board of Underwriters which provide that liability shall not extend to cover more than the loss of profits on the sales which are prevented and the reduced profit derived from sales actually made when other merchandise can be acquired by the insured. A stipulation should be made to this effect in the other forms in use, with the addition to the definition of profits already suggested[22] that 'in no event shall the profits insured hereunder be considered to be greater than the amount of profit which would have been realized had the merchandise described herein been sold in the usual course of the insured's business over the period of time which would have been required for its sale and at the prices then prevailing.' By such a clause as this the insured would be allowed a profit based upon the selling price of the goods on the day of the fire or over the time which would have been necessary for him to sell them, whichever is less. If the price on the day of the fire is less than the average of the prices thereafter, the insured would be indemnified in full for he could go into the market and, with the proceeds of his fire insurance and profit insurance policies, buy goods to replace those destroyed or damaged. If the future prices were lower than the price on the day of the fire he would be fully indemnified, for his profit would have been determined by the prices at which he would have sold the goods and his loss would be determined on the same basis.

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[22] See p. 200.

Loss Adjustments.

The presence of an insurable interest in the profits or commissions which would have been realized from the sale of merchandise, and the fact that a loss on the merchandise has been sustained, can be ascertained easily. Rarely will profits insurance be carried without the merchandise itself being insured, so the facts developed in the adjustment of the merchandise loss will be available and useful to the profits insurance adjuster. His problem is to establish as equitable a basis for determining the amount of profits lost as is consistent with the terms of the insurance contract. If insurance is carried under the second type of form the insurer is liable for "any ascertained loss of profits and/or commissions" on the destroyed or damaged goods, "not exceeding . . . an amount equal to the profits and/or commissions on said merchandise which would have been receivable by the insured if said merchandise had been sold in an undamaged condition on the date of the fire at the insured's rate of profits and/or commissions."[23] If insurance is carried under a form of the first type the form requires that "the profits and/or commissions on such merchandise shall be ascertained," and specifies the same limit as in the preceding form except for slight variation in wording necessitated by the other provisions of the form.

The loss of profits or commissions will depend upon the amount of goods which have been destroyed or their value, and either their market price at the time of the fire or the usual rate of profits or commissions realized by the insured. The merchandise loss adjustment statement will contain a statement of the quantity and type of goods destroyed or damaged, their value, and the amount of loss on each. The adjuster then must determine the market price of the goods on the day of the fire, if such a price is available, in which case the difference between it and the actual undamaged value of the goods, as set forth in the merchandise loss adjustment, will establish the insured's gross loss of profits. If the goods consist of merchandise of various

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[23] From Eastern Underwriters' Association Form No. 2. *Rules*, p. 16.

classes the profits should be computed as above for each class separately. If no reliable market prices are available, and it has been the insured's custom to sell the goods at a price equal to his cost plus a flat profit per article or plus a percentage on cost, or if the interest insured is that of commissions on sales, the amount of the loss will be differently determined. Where the mark-up is a flat amount per article this amount must be definitely determined for each class of articles. These can be checked by an inspection of the insured's books. The product of the mark-up and the quantity of each class of goods destroyed or damaged, as stated in the merchandise loss adjustment, will determine the gross loss of profits in this case. Similarly, the rate of profit on cost may be checked and applied to the sound value of the goods lost. If the interest insured is that of a commission merchant whose rate of commission is based upon the selling price of the goods, the rate of commission may be definitely established by reference to the written contract, if one exists, by reference to the consignor if the contract is oral, or by an inspection of the insured's books. The market price of the goods on the day of the fire must also be determined and the rate of commission applied to it to establish the gross commission loss.

The gross loss which has been determined is the limit of the insurer's liability under either type of form which may be used. If the loss had resulted from the total destruction of all of the goods, the adjuster would need only to find the amount of the expenses which would be avoided by the insured, and the net loss would be established. This amount would be paid in full under either form if such an amount of insurance were carried, or the whole amount of insurance would be paid if it were less.

When the loss results from damage to the goods rather than from their destruction, the adjustment procedure from this point will depend upon the type of form used to cover the risk. The first type of form requires that the percentage of loss or damage to merchandise be ascertained. The loss on merchandise is stated to "include the damage to merchandise as shown by the final outcome of the merchandise loss adjustment as made by the companies insuring the same, including the result of any salvage handling operations, whether completed before or after

such adjustment."[24] If the insurer does not take over the damaged goods the amount of the loss on merchandise paid by it fixes the amount of the loss on merchandise. If the insurer takes over the damaged goods the adjuster must estimate the value of the salvage or await the results of the salvage handling operations of the insurer to determine its value. This value of the salvage is deducted from the amount of the loss paid by the insurer on the goods and the remainder represents the amount of the loss on merchandise.[25] The proportion between this and the sound value of the damaged goods determines the percentage of loss on merchandise. The gross loss on profits has been determined. From it will be deducted those expenses which are not avoidable and the total net loss is found. The insurer is responsible for that proportion of this total net loss which is represented by the percentage of loss on merchandise, provided sufficient insurance is carried to meet with the requirement of the coinsurance clause. If the net loss of profit which would have resulted from the total destruction of the damaged goods had been determined to be $5000 and the percentage of loss on merchandise had amounted to 40 per cent, the insurer would be responsible for 40 per cent of $5000, or $2000. If an inadequate amount of insurance were carried the insurer's liability would be proportionately reduced. To determine the adequacy of the amount of insurance the adjuster would be required to find the profit which would have been lost had all goods been destroyed by the fire. The total net loss of $5000 was that which would have been suffered if the damaged goods had been destroyed. If only 50 per cent of the goods were damaged, another $5000 would have been lost had the sound goods been destroyed. If 100 per cent insurance were required under the coinsurance clause attached to the form, $10,000 would be the required

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[24] From Eastern Underwriters' Association Form No. 1. *Rules*, p. 15.

[25] If the insurer could sell the salvage at a price which would have included a profit for the insured had the goods not been taken over, the deduction of this larger amount from the amount of the loss paid including payment for salvage will reduce the percentage of loss on merchandise. This, in turn, will reduce the amount of profits which the insured can claim as lost under the policy, in spite of the fact that he has lost his whole profit on the salvage since it was taken over by the insurer on the goods.

amount of insurance. If the insurance carried were only $6000 the insurer's liability would be reduced to 6000/10,000 of the $2000 loss, or $1200.

If the coverage had been under a form of the second type, the adjuster, having arrived at the gross profitwhich would have been lost had the damaged goods been completely destroyed, would find in the form no guide for determining the actual loss sustained when the goods are only damaged. From the gross loss of profits must be deducted the expenses, if any, which can now be avoided and also the profits which the insured can actually realize on the sale of the goods in their damaged condition.[26] The actual value of the salvaged goods is the difference between the sound value of the goods and the amount of loss paid by the insurers on the goods. The adjuster must then determine whether these goods can be sold for as much as, or more than, the value indicated above, and what expenses will be connected with their sale. If he decides that more can be realized than their value under the adjustment and the expenses which will be incurred in their sale, this amount of profit will be deducted from the total net loss of profit and the balance paid under the insurance.[27] If a coinsurance clause were included in the form and the amount of insurance were inadequate (determined on the same basis as under the first type of form) the insurer's liability would be proportionately reduced.

Profits and Commissions Insurance Rates.

When the interest in profits and commissions is insured under a form in which the insurer's liability extends only to cover the loss of profits in proportion to the amount of loss on the merchandise, the insurance is written at the same rate as that applying on the particular merchandise. If a coinsurance clause is embodied in the form the corresponding coinsurance rate upon the goods is the rate used. This is equitable insofar as rates are

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[26] If the goods are taken over by the insurers on the goods the insured's loss is treated as though the goods had been destroyed. In other words, he receives his whole profit on such goods.

[27] A loss on commissions would be determined in the same way.

concerned, for the insurer's liability under the profits insurance will always be the same proportion of the amount at risk as the loss under the insurance on the goods is to the value of the merchandise. But that is as much as can be said for the form. It was devised to supply the demand for a form which could be written at the same rate as that on the goods. The coverage was made to fit the rate rather than to fit the needs of the insured. The proportion of the insured's recovery under the form to the actual amount of his loss will vary according to circumstances over which he has no control. With good luck in disposing of his damaged goods he can realize the amount of his loss; with poor luck he can realize only a small part of it.

When the second type of form is used the rate is usually double the rate applying on the merchandise. The insurer's liability is greater than under the first type of form since this form contains no artificial limit upon it. Since the first form is equitably rated at the rate on the goods, this form will require a rate greater than that on the goods if it is to be fair to the insurer. Whether the rate in general should be double the rate on the goods or only half again as large can not be determined, for here again the experience of the insurers is not segregated. To arrive at an accurate rate would require a body of properly classified experience. It is evident that while the rate should depend upon the rate for the goods, it should not be the same proportion of the rate for different classes of goods. For example, machinery or hardware may suffer a 10 per cent loss and still be saleable at a price which would allow a good portion of the insured's usual rate of profit to be realized, but a loss of 10 per cent on dress goods, or books, would probably preclude all possibility of realizing any profit on the salvage. These latter goods should carry a higher profits insurance rate in proportion to the rate on the goods than should the former. The only basis for determining the correct proportionate rate for different classes of goods lies in the segregation of data and its classification according to groups of merchandise if the body of experience is too small to classify according to each of the different classes into which the merchandise itself falls.

Commissions of Selling Agents.

The profits and commissions insurance forms, when applied to an interest in commissions, are restricted in their coverage to the commissions on special or consigned stocks in storage. If the interest to be insured is one in commissions arising out of a selling agency contract these forms would not be applicable. At most they would be applied to cover the commissions on the goods in possession of the selling agent at the time of the fire. But if the plant or stock of the principal in the agency contract should be destroyed or damaged, the selling agent would lose commissions until the goods which he is selling could again be furnished to him. Just as the manufacturer or the merchant could cover a loss of this same type under use and occupancy insurance forms, so too can the selling agent utilize these forms. Provision has been made for writing this insurance on the forms used for mercantile risks by defining the term use and occupancy to correspond with the interest which is to be insured.[28] The provision relating to the use of other property of the insured to allow a resumption of business more quickly, has been modified so that the insured is required to use due diligence to obtain goods from other sources to fill orders, but the purpose of the clause remains the same. Rates for the coverage according to the rules of the Eastern Underwriters Association are based upon the use and occupancy insurance rate applicable to the principal's business, 10 per cent extra being charged if this business is a non-manufacturing risk and 25 per cent extra if it is a manufacturing risk. The reason for these increases in rate is that the insured's loss will usually continue over a longer period of time than would the loss of the principal. The principal will be interested in replacing his own stock first if his is a mercantile business. If it is a manufacturing risk the selling agent can receive no goods until the finished stock has been reproduced by the princpal, and this will require time. For this time the principal can claim no loss under his insurance but the selling agent can. Consequently the rates for the coverage of

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[28] *Rules of the Eastern Underwriters' Association*, p. 70.

commissions of selling agents should be higher than those for insurance on the risk out of which the commissions arise. The increase in the rate should not be a straight percentage increase for different risks as it now is, but should depend upon the probable extra time which will be required after the principal may resume business but before the insured selling agent can be supplied with goods ready for sale. Thus if the goods are quickly reproducible after the damage done by the fire to the principal's property has been repaired, the increase in rate should be less than if a longer time would be required, for upon this time depends the extra amount of the insurer's loss.

Conclusions as to Profits and Commissions Insurance.

The field of profits and commissions insurance is considerably limited. The coverage provided under such forms is not necessary when the goods are those for which market value clauses may be used in the insurance on the goods themselves, nor is it necessary when goods have been sold but not delivered, for the policy on the goods may, by endorsement, be extended to cover their selling price. This form of protection usually may not be applied to cover the interest of merchants in profits on the goods in their possession, but use and occupancy insurance forms must be used instead. The amount of the interest in profits and commissions on those goods to which this type of coverage may be applied will almost always be less than their replacement value. Considering all of these limitations upon it, the possible volume of profits and commissions insurance can never amount to more than a relatively small proportion of the amount of insurance on all goods; consequently it will always occupy a position of secondary importance. But its relative importance may be greatly increased. The forms need extensive revisions of the nature indicated before, and rates, based upon the rates on the stock, should be determined specifically for different classes of goods. This will require separation of the experience on this type of insurance from that on the insurance of the goods.

FINIS

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APPENDIX I

Rent Insurance Forms

Eastern Rent Form

Whether Rented or Vacant—Based on Annual Rental Value.

$.....On the rental value of the.....building, with.....roof,
while occupied as.....
and situate.....
.....

The term rental value, wherever used in this contract, shall mean the determined rental less such charges and expenses as do not necessarily continue.

It is hereby provided that if said premises or any part thereof, whether rented at the time or not, shall be rendered untenantable by fire or lightning occurring during the continuance of this policy, this Company shall thereupon become liable for the rental value of such untenantable portions. Loss to be computed from the date of fire or damage by lightning, until such time as the building could, with reasonable diligence and dispatch, be rendered again tenantable, although the period may extend beyond the termination of this policy.

If the insured occupies any portion of said building, a fair rental value of the portion so occupied shall be considered as a part of the rental value insured.

In event of a disagreement as to the time required to restore the premises to the same tenantable condition as before the fire or damage by lightning, or as to the rental value of premises occupied by the insured, the same shall be determined by appraisement or reference in the manner provided in the printed conditions of this policy.

In consideration of the reduced rate at which this policy is written, it is agreed that this Company shall not be liable, under this policy, for a greater proportion of any loss that may occur than the sum hereby insured bears to the rental value of the whole of said premises per annum. Total liability under this policy for any loss shall not exceed the sum insured by this policy, nor this Company's pro rata proportion of all insurance on rental value, whether other insurance covers against loss caused by lightning or not.

Midwestern Rent Form

Whether Rented or Vacant.—Insuring Clause.

The term "rents and/or rental value" wherever used in this policy shall mean the determined rents and/or rental value, less such charges and expenses as do not necessarily continue after the fire.

In case the above described building, or any part thereof, whether rented at the time or not, shall be rendered untentable by fire, this company shall be liable to the insured for not exceeding the actual loss sustained based upon loss of rents and/or rental value of such untenantable parts, not exceeding the sum insured, nor more than one-.....of that amount for any one month, and proportionate part thereof for any period less than one month, loss to be computed from the date of the occurrence of said fire, and to be determined by the time it would require, under ordinary circumstances, to put the premises in tenantable condition; and in case any portion of the building herein described shall be occupied by the insured, for his own use, this policy shall extend to and cover the rental value of such portion so occupied, in the same manner as if under lease to a tenant.

(Other clauses, similar to those of the Eastern form, have been omitted.)

Pacific Rent Form

Whether Rented or Vacant.

* * * * * *

"Average Clause." It is expressly stipulated and made a condition of the contract that, in event of loss, this company shall be liable for no greater proportion thereof than the amount hereby insured bears to..... per cent (.....%) of the annual rental income from the building at the time of fire, less all expenses which in event of total destruction of the building the insured would be relieved of, nor for more than the proportion which this policy bears to the total insurance thereon.

* * * * * *

It is a condition of this insurance that the insured shall not be entitled to compensation on account of inability to construct a building of like character, or delay which may be occasioned by any ordinance or law regulating construction or repair of buildings, or by the suspension, lapse, or cancellation of any license, or by strike or strikes, or for compensation for any other consequential loss. If the building or any material part thereof fall, except as a result of fire, all insurance by this policy shall immediately cease.

APPENDIX II

Leasehold Insurance Forms

Eastern Leasehold Interest Form

(1) This policy for $.....covers its pro rata proportion of the following described insurance:

$.....On the interest of the insured as lessee of premises situate

.....

under lease dated.....19....for the term of.....years and expiring.....19....

(2) The term "interest of the insured as lessee" is hereby defined as the excess of the rental value of such premises over the actual rental payable (including any maintenance or operating charges paid by the insured) during the unexpired term of the insured's lease, whether the premises to be occupied in whole or in part by the insured, or whether they be sub-let to other tenants.

(3) It is a condition of this insurance that the following is a full and true copy of all the conditions of said lease relating to damage to the building by fire, and that no change shall be made in said conditions unless consented to by this Company in writing endorsed on this policy:

.....

(4) It is a condition of this insurance that in the event the lease contains no conditions relating to damage to the premises by fire, the statutory requirements of the State in which the property is situated shall govern.

(5) If by fire occurring during the term of this policy the premises above described are so damaged by fire as to cause the cancellation, by the lessor, of the aforesaid lease in accordance with its terms and conditions as entered above, this insurance shall be liable for the actual loss sustained to the "interest of the insured as lessee", as above defined, pro rata with other insurance hereon, if any. Such loss shall not exceed the sum which, placed at interest compounded annually at the rate of four per cent (4%) per annum, will be the equivalent of the "interest of the insured as lessee" for the unexpired term of the lease as such interest would have accrued monthly.

(6) It is a condition of this insurqnce that the amount of this policy shall be automatically reduced at the rate of $.....per month from its inception.

(7) It is a condition of this insurance that if the premises be rendered wholly untenantable by fire and the lease not cancelled, this Company shall be liable for its pro rata proportion of the actual loss sustained at a rate of not exceeding $.....per month, and pro rata proportion thereof for less than one

month, and a pro rata proportion thereof for partial untenantability, for the length of time, not limited by expiration of this policy, as shall be required with the exercise of reasonable diligence and dispatch to render the premises again tenantable, but not extending beyond the expiration of the lease.

(8) In consideration of the special rate at which this contract of insurance is written, this policy shall not be cancelled by the assured for the purpose of rewriting same for a term extending beyond the date of expiration named in this policy, or for the purpose of rewriting same for a smaller amount at any time during the life of this policy. This provision, however, shall not prohibit the assured from recovering return premium on a short rate basis in the event of the termination of his leasehold interest from any cause.

Midwestern Leasehold Interest Form

(1) Same as clause (1)—Eastern Form.

(2) The term "interest of the insured as lessee" is hereby defined as the excess of the rental value of such premises over the actual rental payable (including any maintenance or operating charges paid by the insured) during the unexpired term of the insured's lease, whether the premises be occupied in whole or in part by the insured, or whether they be sub-let to other tenants, and is estimated at the date of this policy at $.....per month.

The term "net leasehold interest" as used herein is hereby defined as that sum which placed at 4% interest compounded annually will be equivalent to the interest of the insured as lessee for each separate month of the lease unexpired.

(3) Same as clause (3)—Eastern Form.

(4) Same as clause (4)—Eastern Form.

(5) It is a condition of this insurance that the amount of this policy shall be automatically reduced from month to month as set forth opposite each respective month in the net leasehold interest table which accompanies this policy form, and a pro rata proportion for less than one month.

(6) In the event of cancellation of the lease by the lessor after loss or damage by fire in accordance with the conditions of the lease hereinbefore quoted (or by statutory requirements in the absence of a Fire Clause) this Company shall be liable to the insured for the actual loss sustained not exceeding whatever amount of insurance remains in force at the date of the fire to be computed as follows: The interest of the insured as lessee as determined by adjustment shall be paid for the first three months succeeding the fire, and the net leasehold interest shall be paid for the remaining months of the unexpired lease. (See table on the reverse side of this form.)

(7) Same as clause (7)—Eastern Form.

(8) Other Insurance clause.

(9) In the event of cancellation of said lease by the lessor, in accordance with its terms, or in accordance with the statutes applicable, should the lessee remain in possession as tenant at will under a new lease or otherwise, this Company shall be liable for the actual loss sustained by the insured to his interest, which loss shall not exceed the limit of liability set forth herein.

(10) In consideration of the special rate and/or conditions under which this insurance is written, this policy shall not be cancelled by the insured for the purpose of rewriting same for a term extending beyond the date of expiration named in this policy, nor for the purpose of rewriting same for a smaller amount at any time during the life of this policy, excepting where there has been a corresponding reduction in the monthly interest of the insured as lessee in which event the earned premium on the average amount of liability cancelled shall be computed in the same manner in which the original premium is computed and at the customary short rate.

(11) If this entire policy is cancelled, the earned premium shall be computed upon the average amount at risk for the expired term in the same manner in which the original premium is calculated.

(12) It is a condition of this insurance that this Company shall not be liable for any loss to leasehold interest by reason of any act or omission of the insured, or by the insured exercising an option to cancel the lease, or by the enforcement of any ordinance or law regulating or prohibiting construction or repair of buildings, or by the suspension, lapse or cancellation of any license, or for any other remote loss.

(13) Appraisal clause.

On the reverse side of the form there is printed an illustration of the method of determining the premium, and also a copy of the leasehold interest table reproduced on pages 128-130 herein.

APPENDIX III

Use and Occupancy Insurance Forms

(Per Diem)

Use and Occupancy Form No. 1

For Manufacturing Plants in Steady Operation—"Straight U. & O."

$.....On the Use and Occupancy of the property described below:

(1) The conditions of this contract are that if the building(s).....
.....
situate.....
.....
and occupied as.....
.....
and/or machinery and/or equipment.....[Insert here "and/or raw stock" if liability due to damage to or destruction of raw stock is to be included] contained therein, be destroyed or damaged by fire occurring during the term of this policy so as to necessitate a total or partial suspension of business, this Company shall be liable under this policy for the actual loss sustained consisting of:

I. Net profits on the business which is thereby prevented;

II. Such fixed charges and expenses as must necessarily continue during a total or partial suspension of business, to the extent only that such fixed charges and expenses would have been earned had no fire occurred;

III. Such expenses as are necessarily incurred for the purpose of reducing the loss under this policy;

for not exceeding such length of time, commencing with the date of the fire and not limited by the date of expiration of this policy, as shall be required with the exercise of due diligence and dispatch to rebuild, repair or replace such part of said building(s) and machinery and equipment..... [Insert here "and raw stock", if liability due to damage or to destruction of raw stock is included] as may be destroyed or damaged subject to the following conditions and limits, to wit:

(2) Total Suspension Clause: The per diem liability under this policy during the time of total suspension of business of all the properties described herein shall be limited to the "Actual Loss Sustained", not exceeding 1/300 of the amount of this policy for each business day of such suspension, except that in the case of business being operated on Sundays and/or holidays, in which event the said per diem liability shall not exceed 1/365 of the amount of this

policy for each business day of such suspension, due consideration in either case being given to the experience of the business before the fire and the probable experience thereafter.

(3) Partial Suspension Clause: The per diem liability under this policy during the time of a partial suspension of business shall be limited to the "Actual Loss Sustained", not exceeding that proportion of the per diem liability that would have been incurred by a total suspension of business which the actual per diem loss sustained, during the time of such partial suspension, bears to the per diem loss which would have been sustained by a total suspension of business, for the same time, of all properties described herein, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

(4) The term "raw stock" wherever used in this contract shall be construed to mean materials and supplies usual to the insured's business in the state in which the insured receives them.

The term "stock in process" wherever used in this contract shall be construed to mean "raw stock" which has undergone any aging, seasoning, mechanical or other process of manufacture at the above location but which has not become "finished stock."

The term "finished stock" wherever used in this contract shall be construed to mean any stock which in the ordinary course of the insured's business is ready for packing, shipment or sale.

(5) The word "day" however modified, wherever used in this contract, shall be held to cover a period of twenty-four hours.

(6) It is a condition of this insurance that the insured shall not be entitled to compensation on account of loss which may be occasioned by any ordinance or law regulating or prohibiting construction or repair of buildings, or by the suspension, lapse or cancellation of any license or lease, or for any other remote loss.

(7) It is a condition of this insurance that as soon as practicable after any loss, the insured shall resume complete or partial operation of the property herein described and shall make use of other property, if obtainable, if by so doing the amount of loss hereunder will be reduced, and in the event of the loss being so reduced such reduction shall be taken into account in arriving at the amount of the loss hereunder.

(8) It is a condition of this insurance that surplus machinery or duplicate parts thereof, equipment or supplies, and (if this policy covers liability for suspension of business due to damage to or destruction of raw stock) surplus or reserve raw stock, which may be owned, controlled or used by the insured, shall in the event of loss, be used in placing the property in condition for continuing or resuming business.

(9) It is a condition of this insurance

a. That this Company shall in no event be liable for loss resulting from damage to or destruction of finished stock or for the time required to reproduce any finished stock which may be damaged or destroyed;

b. That if liability for suspension of business due to damage to or destruction of raw stock is specifically assumed hereunder, this policy subject in all its terms, conditions, and/or limitations and without increasing the amount of said policy shall include such additional time, if any, not exceeding thirty business days, as may be required with the exercise of due diligence and despatch to replace any stock in process damaged or destroyed and/or to restore the same to the state of manufacture in which it stood at the time of the fire. Provided, however, that if there be other insurance covering in any manner the loss insured against by this policy, this Company shall be liable only pro rata with such other insurance, irrespective of whether such other insurance includes liability for additional time, if any, involved in replacement and/or restoration of stock in process;

c. That if liability for suspension of business due to damage to or destruction of raw stock is specifically assumed hereunder such liability shall be limited to that period of time for which the damaged or destroyed raw stock would have made operations possible.

(10) It is a condition of this insurance if this policy covers liability for suspension of business due to damage to or destruction of building(s), machinery and equipment only, that this Company shall not be liable for any loss due to damage to or destruction of any stock whether raw, in process or finished.

(11) It is a condition of this insurance that in case the insured and this Company are unable to agree as to the time necessary to rebuild, repair or replace the described property, and/or the value of the subject of this insurance, and/or the amount of loss thereon the same shall be determined by appraisal in the manner provided by this policy, the provisions of which policy shall govern in all matters pertaining to this insurance except as herein otherwise provided.

(12) The liability hereunder shall not exceed the amount of insurance by this policy, nor a greater proportion of any loss than the insurance hereunder shall bear to all insurance, whether valid or not, and whether collectible or not, covering in any manner the loss insured against by this policy.

(13) In the event of the insurance hereunder being reduced by payment of loss, such reduction shall apply only to the amount of the policy, the daily limit of liability being unaffected thereby.

(Per Diem)

Use and Occupancy Form No. 2

For Mercantile or Non-Manufacturing Risks in Steady Operation—"Straight U. & O."

$.....On the Use and Occupancy of the property described below:

(1) The conditions of this contract are that if the building(s).....
.....
situate.....
.....
and occupied as.....
.....
and/or machinery and/or equipment.....[Insert here "and/or stock" if liability due to damage to or destruction of stock is to be included] contained therein, be destroyed or damaged by fire occurring during the term of this policy so as to necessitate a total or partial suspension of business, this Company shall be liable under this policy for the actual loss sustained consisting of:

I. Net profits on the business which is thereby prevented;

II. Such fixed charges and expenses as must necessarily continue during a total or partial suspension of business, to the extent only that such fixed charges and expenses would have been earned had no fire occurred;

III. Such expenses as are necessarily incurred for the purpose of reducing the loss under this policy;

for not exceeding such length of time, commencing with the date of the fire and not limited by the date of expiration of this policy, as shall be required with the exercise of due diligence and dispatch to rebuild, repair or replace such part of said building(s) and machinery and equipment..... [Insert here "and stock" if liability due to damage to or destruction of stock is included] as may be destroyed or damaged subject to the following conditions and limits, to wit:

(8) It is a condition of this insurance that surplus machinery or duplicate parts thereof, equipment or supplies, and (if this policy covers liability for suspension of business due to damage to or destruction of stock) surplus or reserve stock, which may be owned, controlled or used by the insured shall, in the event of loss, be used in replacing the property in condition for continuing or resuming business.

(Clauses (2), (3), (5), (6), (7), (10), (11), (12) and (13) of Form No. 1 are also included. Clauses (4) and (9) of Form No. 1 do not appear in this form. Clauses (1) and (8) of Form No. 1 are modified as above.)

(Weekly)

Use and Occupancy Form No. 3

For Mercantile or Non-Manufacturing Risks in Steady Operation—"Straight U. & O."

(2) Total Suspension Clause: The liability per week under this policy during the time of total suspension of business of all the properties described herein shall be limited to the "Actual Loss Sustained" not exceeding 1/52 of the amount of this policy for each week of such suspension, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

(3) Partial Suspension Clause: The liability per week under this policy during the time of a partial suspension of business shall be limited to the "Actual Loss Sustained" not exceeding that proportion of the liability per week that would have been incurred by a total suspension of business which the actual loss per week sustained during the time of such partial suspension, bears to the loss per week which would have been sustained by a total suspension of business, for the same time, of all properties described herein, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

(5) The word "business" wherever used in this contract shall be construed to mean: "The carrying on of the business operations usual to the class of the assured."

The word "week" however modified, wherever used in this contract shall be construed to mean seven consecutive calendar days.

(Other clauses are the same as those of Form No. 2.)

(Per Diem)

Use and Occupancy Form No. 4

For Manufacturing Plants Having Seasonal Operations or Fluctuating Earnings

Pro Rata Clause: The amount for which this policy is issued applies pro-rata to each of the following per diem amounts in the proportion that the amount of this policy bears to the aggregate of said per diem amounts multiplied by the respective number of days during which each applies.

(2) Total Suspension Clause: The per diem liability under this policy during the time of total suspension of business of all the properties described herein shall be limited to the "Actual Loss Sustained", not exceeding the amounts

designated for each day of the respective periods defined in the following table and during no other time, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

	Month-Day		Month-Day	
For each business day from	.....	to the following	.....	(incl.) $.....
For each business day from	.....	to the following	.....	(incl.) $.....
For each business day from	.....	to the following	.....	(incl.) $.....
For each business day from	.....	to the following	.....	(incl.) $.....
For each business day from	.....	to the following	.....	(incl.) $.....
For each business day from	.....	to the following	.....	(incl.) $.....

(3) Partial Suspension Clause: The per diem liability under this policy during the time of a partial suspension of business shall be limited to the "Actual Loss Sustained", not exceeding that proportion of the per diem liability that would have been incurred by a total suspension of business which the actual per diem loss sustained, during the time of such partial suspension, bears to the per diem loss which would have been sustained by a total suspension of business, for the same time, of all properties described herein, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

(Other clauses are the same as those of Form No. 2.)

(Per Diem)

Use and Occupancy Form No. 5

For Mercantile or Non-Manufacturing Risks Having Seasonal Operations or Fluctuating Earnings

---

Clauses (1) and (8) are the same as those for Form No. 2.

Clauses (2) and (3), including the Pro Rata Clause are the same as those for Form No. 4.

Clauses (5), (6), (7), (10), (11), (12) and (13) are the same as those for Form No. 1.

Clauses (4) and (9) of Form No. 1 do not appear in this form.

(Weekly)

Use and Occupancy Form No. 6

For Mercantile or Non-Manufacturing Risks Having Seasonal Operations or Fluctuating Earnings

Pro Rata Clause: The amount for which this policy is issued applies pro

rata to each of the following weekly amounts in the proportion that the amount of this policy bears to the aggregate of said weekly amounts multiplied by the respective number of weeks during which each applies.

(2) Total Suspension Clause: The liability per week under this policy during the time of total suspension of business of all the properties described herein shall be limited to the "Actual Loss Sustained" not exceeding the amounts designated for each week of the respective periods defined in the following table and during no other time, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

Month-Day Month-Day

For each week from.....to the following.....(incl.) $.....
For each week from.....to the following.....(incl.) $.....
For each week from.....to the following.....(incl.) $.....
For each week from.....to the following.....(incl.) $.....
For each week from.....to the following.....(incl.) $.....

(3) Partial Suspension Clause: The liability per week under this policy during the time of a partial suspension of business shall be limited to the "Actual Loss Sustained" not exceeding that proportion of the liability per week that would have been incurred by a total suspension of business which the actual loss per week sustained during the time of such partial suspension bears to the loss per week which would have been sustained by a total suspension of business, for the same time, of all properties described herein, due consideration being given to the experience of the business before the fire and the probable experience thereafter.

(Other clauses are the same as those of Form No. 3.)

Use and Occupancy Co-Insurance Form No. 7

For Manufacturing Risks

This policy, covering in the aggregate amount of $.....applies pro rata to each of the following amounts:

This policy covers, subject to all its terms and conditions, the Use and Occupancy of the property described as follows:

.....
.....
.....occupied by the insured as.....situated.....City or Town of .....State of.....

A. If the building(s) and/or structures and/or machinery and equipment and/or Raw Stock contained therein (strike out "and/or Raw Stock", if rate used does not contemplate raw stock coverage) be destroyed or damaged by fire occurring during the term of this policy so as to necessitate a total or partial suspension of business, this Company shall be liable under this policy for the "Actual Loss Sustained", for not exceeding such length of time as would be required with the exercise of due diligence and dispatch, to rebuild, repair or replace such part of the property described as covered by this policy, as has been destroyed or damaged, commencing with the date of the fire and not limited by the date of expiration of this policy, to wit:

Item I. $.....on (a) the net profit which is thereby prevented from being earned and

(b) such charges and other expenses, including salaries of officers—executives, department managers—employees under contract and other important employees, as must necessarily continue during a total or partial suspension of business, to the extent only that such charges and expenses would have been earned had no fire occurred.

This Item (I) covers expense of necessary heat, light or power, the cost of which is prevented from being earned during the time of total or partial suspension of business caused by fire. This Item (I) *does not cover* any portion of the insured's ordinary payroll described in Item II.

Item II. $.....on the insured's entire ordinary payroll for a period of time not in excess of 90 consecutive days immediately following loss or damage by fire, which may continue during a total or partial suspension of business, covering only to the extent necessary to resume the normal business of the insured with the same quality of service which existed immediately preceding the fire, and which would have been earned had no fire occurred.

This Item (II) *does not cover* any portion of salaries described in Item I.

Liability under this Item (II) including time, if any, to replace stock in process and/or raw stock which may be damaged or destroyed shall not extend for more than 90 days after loss or damage by fire.

B. This policy covers such expenses as are necessarily incurred for the purpose of reducing any loss under this policy, not exceeding, however, the

amount by which the loss covered is thereby reduced, it being a condition that if there is insurance covering Use and Occupancy loss described under both Items (I and II), the said expenses shall be apportioned to these Items in the proportion that the reduction in amount of loss under each Item bears to the reduction under both Items.

C. The amount of net profit and/or charges and expenses covered under Item I or II, shall be determined, whether for the purpose of ascertaining the amount of loss sustained or for the application of the Co-Insurance Clause, by giving due consideration to the experience of the business before the fire and the probable experience thereafter.

D. Co-Insurance Clause: In consideration of the rate and form under which Items I and II of this policy are written, this Company shall be liable, in the event of loss, for no greater proportion of such loss, which shall include expenses, if any, covered by paragraph B, than the amount hereby covered under each respective Item, bears to,

(a) Under Item I, 100% of the sum of the annual net profits and the annual charges and other expenses (except expense of heat, light and power and expense incurred for purpose of reducing any loss under this policy), described as covered by Item I, that would have been earned (had no fire occurred) during the twelve (12) months immediately following loss or damage by fire, whether or not said charges and other expenses necessarily continue during a total or a partial suspension of business.

(b) Under Item II, 100% of the insured's entire ordinary payroll, excluding only salaries described in Item I, which would have been earned (had no fire occurred) during the ninety (90) consecutive days immediately following loss or damage by fire.

E. Definitions, "Raw Stock", "Stock in Process", "Finished Stock", "Day", "Normal":

(a) The term "Raw Stock", wherever used in this contract shall be construed to mean materials and supplies usual to the insured's business in the state in which the insured received them.

(b) The term "Stock in Process", wherever used in this contract shall be construed to mean, "Raw Stock" which has undergone any aging, seasoning, mechanical or other process of manufacture at the above location, but which has not become "finished stock".

(c) The term "Finished Stock", wherever used in this contract shall be construed to mean any stock which in the ordinary course of the insured's business is ready for packing, shipment or sale.

(d) The word "Day", however modified, wherever used in this contract shall be construed to mean twenty-four consecutive hours.

(e) The word "Normal", however modified, wherever used in this contract, shall be construed to mean the condition that would have existed had no fire occurred.

F. Stock in Process: This policy, subject to all its conditions, and/or limitations, and without increasing the amount of said policy, shall include such additional time, if any, not exceeding thirty (30) consecutive days, as may be required with the exercise of due diligence and dispatch to replace and/or restore any stock in process damaged or destroyed, while in the above-described building(s), or in the open on premises above described, and/or to restore said stock in process to the same state of manufacture in which it stood at the time of the fire.

G. Raw Stock: If liability for suspension of business due to damage to or destruction of raw stock is specifically assumed hereunder, such liability shall be limited to that period of time for which the damaged or destroyed raw stock would have made operations possible.

H. Resumption of Operation and Use of Other Property: As soon as practicable after any loss, the insured shall resume complete or partial operation of the property herein described and shall make use of other property, if obtainable, if by so doing the amount of loss hereunder will be reduced, and in the event of the loss being so reduced such reduction shall be taken into account in arriving at the amount of the loss hereunder.

I. Surplus Equipment and Supplies: Surplus machinery or duplicate parts thereof, equipment or supplies, and surplus or reserve raw stock or stock in process which may be owned, controlled or used by the insured, shall, in the event of loss, be used in placing the property in condition for continuing or resuming business.

J. Lightning and Electrical Exemption Clause:

(a) Except as hereinafter provided, this policy shall cover Use and Occupancy loss resulting directly from damage to the property described as covered, caused by Lightning, meaning thereby the commonly accepted use of the term Lightning, and in no case to include damage by cyclone, tornado or windstorm.

(b) This Company shall not be liable for any Use and Occupancy loss resulting from any electrical injury, disturbance or damage to dynamos, exciters, lamps, switches, motors or other electrical appliances or devices whether from artificial or natural causes, unless fire ensues and then only for such Use and Occupancy loss caused by such ensuing fire.

(c) Liability under the above Lightning and/or Electrical Exemption Clause, shall be subject to all the terms and conditions of this form and the policy to which it is attached, and if there is any other Use and Occupancy insurance on said property, this Company shall be

liable only pro rata with such other insurance for Use and Occupacy loss caused by Lightning, whether such other insurance be against loss by Lightning or not.

K. Appraisal Clause and General Policy Conditions and Provisions: In case the insured and this Company are unable to agree as to the value of the subject of this insurance, and/or the amount of loss thereon, and/or the time necessary to rebuild, repair or replace the premises and/or buildings and/or structures and/or machinery and equipment, and/or raw stock if liability due to damage to or destruction of raw stock be included, the same shall be determined by appraisal in the manner provided by this policy. The conditions and provisions of this policy shall govern in all matters pertaining to this insurance except as herein otherwise stipulated.

L. Special Exclusions: This Company shall not be liable for any loss resulting from damage to or destruction of finished stock, nor for the time required to reproduce any finished stock which may be damaged or destroyed, nor for any loss which may be occasioned by any ordinance or law regulating construction or repair of buildings, or by suspension, lapse or cancellation of any lease or license, contract or order, or for any other consequential loss, nor for any remote loss.

M. Limit of Liability: The liability under the respective Items of this policy shall not exceed the amount of insurance thereunder, nor a greater proportion of any loss than the insurance thereunder shall bear to all insurance, whether valid or not, and whether collectible or not, covering in any manner the loss insured against by the respective Items of this policy.

Use and Occupancy Co-Insurance Form No. 8
For Mercantile or Non-Manufacturing Risks

* * * * * *

A. If the building(s) and/or structures and/or machinery and equipment contained therein, be destroyed or damaged by fire occurring during the term of this policy so as to necessitate a total or partial suspension of business, this Company shall be liable under this policy for the "Actual Loss Sustained", for not exceeding such length of time as would be required with the exercise of due diligence and dispatch, to rebuild, repair or replace such part of the property described as covered by this policy as has been destroyed or damaged, commencing with the date of the fire and not limited by the date of expiratio of this policy, to wit:

Item I. $.....on (a) the net profit which is thereby prevented from being earned and

(b) such charges and other expenses, including salaries of officers—executives, department managers—employees under contract and other important employees, as

must necessarily continue during a total or partial suspension of business, to the extent only that such charges and expenses would have been earned had no fire occurred.

This Item (I) covers expense of necessary heat, light or power, the cost of which is prevented from being earned during the time of total or partial suspension of business caused by fire.

This Item (I) *does not cover* any portion of the insured's ordinary payroll described in Item II.

Item II. $.....on the insured's entire ordinary payroll for a period of time not in excess of 90 consecutive days immediately following loss or damage by fire, which may continue during a total or partial suspension of business, covering only to the extent necessary to resume the normal business of the insured with the same quality of service which existed immediately preceding the fire, and which would have been earned had no fire occurred.

This Item (II) *does not cover* any portion of salaries described in Item I.

Liability under this Item (II) including additional time, if any, to replace stock which may be damaged or destroyed, shall not extend for more than 90 days after loss or damage by fire.

(Clauses B, C and D of this form are the same as those of Form No. 7.)

E. Definition of "Day" and "Normal": The word "Day," however modified, wherever used in this contract shall be construed to mean twenty-four consecutive hours.

The word "Normal," however modified, wherever used in this contract shall be construed to mean the condition that would have existed had no fire occurred.

F. Stock: This policy, subject to all its terms, conditions, and/or limitations, and without increasing the amount of said policy, shall include such additional time, if any, not exceeding thirty (30) consecutive days, as may be required with the exercise of due diligence and dispatch, to replace any stock damaged or destroyed while in the above-described building(s), or in the open on premises above described, and/or to restore the same to the same condition in which it stood at the time of the fire.

(Clause G of Form No. 7 does not appear in this form.)

H. Resumption of Operation and Use of Other Property: As soon as practicable after any loss, the insured shall resume complete or partial operation of the property herein described and shall make use of other property, if obtainable, if by so doing the loss hereunder will be reduced, and in the event of the loss being so reduced such reduction shall be taken into account in arriving at the amount of the loss hereunder.

I. Surplus Equipment and Supplies: Surplus machinery or duplicate parts thereof, equipment or supplies, and surplus or reserve stock, which may be owned, controlled or used by the insured, shall, in the event of loss, be used in placing the property in condition for continuing or resuming business.

(Clauses J and K of this form are the same as those of Form No. 7.)

L. Special Exclusions: This Company shall not be liable for any loss which may be occasioned by any ordinance or law regulating construction or repair of buildings or by the suspension, lapse or cancellation of any lease or license, contract or order, or for any other consequential loss, nor for any remote loss.

(Clause M of this form is the same as that of Form No. 7.)

APPENDIX IV

Co-Insurance Use and Occupancy Work Sheet

Not all the printed items will be applicable to every business and in some cases it may be necessary to insert others in the blank spaces provided for that purpose. The work sheet is intended to assist the insured in determining the amount of insurance desired.

Item I

(a) NET PROFIT for year ending....., 19....$.....
Estimated increase or decrease.....$.....
Estimated Net Profit for a period of one year..... $.....

(b) CHARGES AND EXPENSES ESTIMATED FOR A FULL PERIOD OF ONE YEAR

Note—In filling out the values applying under Item I (b) the full annual amount of charges and expenses should be entered, whether or not a particular charge continues for a full period of one year. In short, ALL entries should be annual amounts.

1. Salaries of:
   Officers.....$.....
   Executives..... .....
   Department Managers..... .....
   Employees under contract..... .....
   Other important employees..... .....
2. Taxes..... .....
3. Interest on notes, bonds, mortgages, etc..... .....
4. Rents where buildings are owned or if leased, where there is no relief in event of fire. (See terms of your lease.)..... .....
5. Royalties, or other charges of same type, that continue in whole or in part..... .....
6. Insurance premiums..... .....
7. Advertising expense which necessarily continues.... .....
8. Special contracts..... .....
9. Continuing membership dues or subscriptions..... .....
10. Directors' fees..... .....
11. Continuing accounting and legal fees..... .....
12. Sums earned to offset depreciation..... .....
13. Miscellaneous and special charges..... .....
    ....

Total of Charges and Expenses..... $.....

TOTAL INSURANCE REQUIRED UNDER ITEM I (i. e. Net Profits and Charges added).. $.....

Item II

Note: The sum entered under Item II should be the full ordinary payroll for the three consecutive months in which the ordinary payroll is the largest.

(a) THE INSURED'S ENTIRE ORDINARY PAYROLL, not including any salaries described in Item I, for a period of ninety (90) consecutive days.

TOTAL INSURANCE REQUIRED UNDER ITEM II.$.....

Date.....

APPENDIX V

Schedule for the Measurement of the Use and Occupancy Hazard Manufacturing Risks

The following schedule was framed to measure properly the Use and Occupancy hazard of Manufacturing Risks during normal replacement conditions, and should be so applied as far as its separate items are concerned.

Definition: The expression "Domestic Market" as used herein means the market to be found in the forty-eight States of the United States of America in which machinery may be promptly obtained. ("Foreign Markets" which are connected with the Domestic Market by rail, shall be classed the same as the Domestic Market.)

Schedule

Note: This schedule is for determining the rate on manufacturing risks consisting of one building, its adjoining and communicating additions and connections, or on a group of buildings rated as a single fire risk.

BASIS RATE:	Covering Building and (or) Machinery and (or) Equipment and Raw Stock.
If 50% or more of floor area, including basements and sub-basements, is of fireproof construction, 80% of	80% Coins. Building rate.
If less than 50% of floor area, including basements and sub-basements, or if none of building is of fireproof construction, 70% of	80% Coins. Building rate.

Note: When there is no coinsurance deduction allowed under the schedule applying thereto, take 70% of the flat or gross rate in all cases.

Whenever a risk is entitled under the schedule applying thereto, to have an 80% coinsurance rate, such rate must be used as a basis in computing the Use and Occupancy rate. If rate as published is based on other than 80% coinsurance, such rate must be resolved to the 80% coinsurance level.

All charges and credits under items 1, 2 and 3 are percentages of basis rate and are cumulative, unless otherwise stated.

1. MACHINERY:
   a. Not obtainable in domestic market 50%
   b. Obtainable in domestic market, but only as made on special order (not cumulative with a.) 20%

2. PROCESS:

a. If the various stages of the manufacturing process are so interdependent that the process must be continuously carried on so that the crippling of a single machine or process would cause an interruption of the entire process in all sections 20%

Note: Power plant machinery (engine, boilers, generator or motor) shall not be considered in applying Item 2. a.

b. In addition to the charge under 2. a. for process, including the picking of the stock, charge when the stock picked is in whole or in part cotton (cumulative with 2. a.) 20%

3. POWER CREDIT:

a. If machines in machinery divisions are separately operated by individual motor drive supplied with current generated in a separate fire division 10%

b. If two or more groups of machines in machinery divisions are separately operated by motor drive supplied with current generated in a separate fire division 5%

c. If there are two or more independent sources of power each of sufficient capacity to operate the plant and so located in reference to each other that both sources will not be normally subject to damage by the same fire 10%

Note 1: If credit is given under either 3 (a) or 3(b) reduce credit under 3 (c) to 5%.

Note 2: No credit under 3 (c) to be made when all sources of supply are from the outside.

Note 3: Credits under 3 (a) and 3 (b) are not cumulative.

If rate is to include replacement of raw stock in addition to building and equipment replacement add:

4. RAW STOCK:

If stock is obtainable only during certain seasons of the year, or for any other reason is not readily obtainable in the open market 50%

Note 1: In rating plants, not a single fire division, use double the above charges in obtaining rate for warehouses used principally for storage of raw stock.

Note 2: In obtaining rate for power houses or warehouses used solely for storage of finished stock, no stock charges are to be used.

Note 3: If rate for coverage of replacement of raw stock only is desired, determine basis rate as indicated by taking the proper percentage of the 80% coinsurance contents rate instead of building rate and apply raw stock percentage charge as given in Item 4.

RULES FOR RATING

Plants Not a Single Fire Risk

1. Rate each building by application of the foregoing schedule.

   Note: Before computing an average rate where there is an interdependency between different buildings, the charge provided under 2 (a) shall be added to all buildings except power houses, and warehouses used exclusively for finished stock, unless the charge has already been applied in the individual rating.

2. Classify all buildings as follows:
   A. Power plant.
   B. Buildings with processes requiring machinery.
   C. Buildings with hand work process only.
   D. Warehouses.

3. In the event that there is more than one building or fire division in any one of the classes A, B, C, D, indicated above, the rate for Use and Occupancy on the class to be obtained by multiplying the Use and Occupancy rate of each building or fire division by the total floor area of such building or fire division and dividing the sum of these results by the total floor area of all buildings and fire divisions in the class.

4. When an insured occupies only a part of a building the floor area actually occupied shall be considered in determining its contribution to an average use and occupancy rate.

5. To obtain the rate for use and occupancy for the entire plant multiply the rate for each class by the percentage indicated in the following table and the sum of the resulting percentages is the use and occupancy rate for the plant.

Table of Percentages

Showing contribution of classes to average rate, with various combinations.

A. Power plant.
B. Buildings with processes requiring machinery.
C. Buildings with hand work process only.
D. Warehouses.

A.	30 —	31 —	35 —	—	38			
B.	50 —	53 —	59 —	80 —	62 —	95 —	—	85
C.	15 —	16 —	—	15 —	—	—	75 —	15
D.	05 —	—	06 —	05 —	—	05 —	25 —	
	100%	100%	100%	100%	100%	100%	100%	100%

Note: Any class C. Building or Section having a total floor area not exceeding 5% and any class D. Building or Section having a total floor area not exceeding 20% of the total floor area of all class A., B., C., and D buildings for which an average rate is being computed may be disregarded. When this results in the elimination of all the buildings of either class the above table is to be applied as if there were no building of that class.

APPENDIX VI

Profits and Commissions Insurance Forms

Eastern Profits and Commissions Form No. 1

$.....On profits and/or commissions on finished merchandise, sold or unsold, while contained in.....

If during the term of this policy such merchandise, or any portion thereof, shall be destroyed or damaged by fire, this Company shall be liable for its pro rata share of any loss of profits and/or commissions (limited and ascertained as stated below) on such merchandise which may result from such fire.

The profits and/or commissions shall in no event exceed such profits and/or commissions as would have been receivable by the insured on the date of the fire from the sale of the damaged and destroyed merchandise in the ordinary course of the insured's business, and the loss on such profits and/or commissions shall be computed as follows:

(1) The percentage of loss or damage to merchandise (as defined below) shall be first ascertained; (2) the profits and/or commissions on such merchandise shall be ascertained; (3) the Company shall be liable for its pro rata share of such percentage of the loss of profits and/or commissions as equals the percentage of loss on merchandise. The loss on merchandise as referred to above shall include the damage to merchandise as shown by the final outcome of the merchandise loss adjustment as made by companies insuring the same including the result of any salvage handling operations, whether completed before or after such adjustment, or if there be no insurance on such merchandise, then by such ascertainment and estimate by the parties hereto as is provided for in the printed portion of this policy.

Where the word "property" is used in this policy or clauses attached hereto, it is understood to mean commissions and/or profits on the merchandise described.

Eastern Profits and Commissions Form No. 2

$.....On profits and/or commissions on merchandise, sold or unsold, while contained in.....

If during the term of this policy such merchandise, or any portion thereof shall be destroyed or damaged by fire, this Company shall be liable for its pro rata share of any ascertained loss of profits and/or commissions on said merchandise which may result from such fire, not exceeding its pro rata share of an amount equal to the profits and/or commissions on said merchandise which would have been receivable by the insured if said merchandise had been sold in an undamaged condition on the date of the fire at the insured's usual rate of profits and/or commissions.

Where the word "property" is used in this policy or clauses attached hereto, it is understood to mean commissions and/or profits on the merchandise described.

Midwestern Profits And/Or Commissions Form

$.....On profits and/or commissions on finished merchandise, sold or unsold, while contained in building(s), or on the premises situated.....

.....

This item shall also cover said merchandise within one hundred (100) feet of the above described building while on sidewalks, streets, alleys, yards, detached platforms and in or on vehicles or railway cars: also on said merchandise while on platforms in contact with above described building.

If during the term of this policy, fire damages or destroys the described merchandise, this company shall be liable under this policy for its proportion of the actual loss of profits and/or commissions sustained by the insured, but if the insured is able to continue sales by the use or acquirement of other merchandise, this company shall not be liable for more than its proportion of the actual loss of profits and/or commissions resulting from an actual loss of sales and/or a reduction in the amount of profits and/or commissions derived from actual sales.

It is a condition of this insurance that as soon as practicable after any loss, the insured shall make use of or acquire other merchandise, if obtainable, for the purpose of continuing sales, if by so doing the amount of loss hereunder will be reduced and in the event of loss being so reduced, such reduction shall be taken into account in arriving at the amount of loss hereunder.

The liability hereunder shall not exceed the amount of insurance by this policy, nor a greater proportion of any loss than the insurance hereunder shall bear to all insurance, whether valid or not, and whether collectible or not, covering in any manner the loss insured against by this policy.

It is a condition of this insurance that in case the insured and this company are unable to agree as to the value of profits and/or commissions and/or the amount of loss under this policy, the same shall be determined by appraisal in the manner provided by the policy to which this form is attached, the provisions of which policy shall govern in all matters pertaining to this insurance, except as herein otherwise provided.

Where the word "property" is used in this policy or clauses attached thereto, it is understood to mean profits and/or commissions on the merchandise described.

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WPCo
PHILA.